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DOCTOR OF PHILOSOPHY

**The personality of company directors as a behavioural risk contributor in the corporate governance process
regulatory intervention as a risk management mechanism.**

Okoye, Ngozi

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Ngozi Okoye

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**THE PERSONALITY OF COMPANY
DIRECTORS AS A BEHAVIOURAL RISK
CONTRIBUTOR IN THE CORPORATE
GOVERNANCE PROCESS: REGULATORY
INTERVENTION AS A RISK
MANAGEMENT MECHANISM**

By

Ngozi Vivian Okoye

**A thesis submitted in fulfilment of the requirements
for the Degree of Doctor of Philosophy at the School
of Law, University of Dundee**

September 2012

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DECLARATION

I hereby declare that this thesis is authored by me, that the work of which this thesis is a record has been done by me, and that it has not been previously accepted for a higher degree at any University.

Ngozi Okoye

CERTIFICATION

This is to certify that Ngozi Okoye has done this research under my supervision, and that she has fulfilled the conditions of Ordinance 14 of the University of Dundee, so that she is qualified to submit for the Degree of Doctor of Philosophy.

Mr Stuart Cross

Senior Lecturer, University of Dundee

ABSTRACT

The reports issued after investigations into some recent and major corporate failures highlight that behavioural issues on the part of company directors are a significant contributory factor to those failures. The events which led to the corporate failures in companies such as the Maxwell Group, BCCI, Enron, WorldCom, Lehman Brothers and RBS illustrate that inappropriate actions and decisions were taken by the directors and these contributed to the failures. This suggests that behavioural issues constitute risks in the corporate governance process as they have the potential to contribute to the occurrence of failures; risk being understood to mean the potential for an undesirable, unexpected and unwanted negative outcome. In any attempt to prevent corporate failures attributable to behavioural issues, the risks associated with the concept of behaviour need to be identified and managed sufficiently. The occurrence of major corporate failures has often led to discussions in government and business circles regarding the issues that contributed to the failures and avenues for preventing similar occurrences in the future. In relation to addressing behavioural issues, it is important to ascertain what constitutes behaviour and ensure that these constituent elements are engaged with in the course of developing preventive mechanisms for such corporate failures. A meaningful solution to the problems of behavioural risks in corporate governance can only be achieved if there is a clear understanding of how the elements which contribute to behaviour do so, as well as the development of mechanisms which take cognisance of the risks accruing from these constituent elements.

This thesis examines behavioural risks in corporate governance, and seeks to ascertain what constitutes behaviour. It finds upon an examination and analysis of literature that “personality” and “situations” are elements which contribute to behaviour. Consideration of risk management mechanisms in corporate governance indicates that the personality aspect of behavioural risks has remained largely unidentified. The thesis then focuses on the personality of company directors as a significant contributory factor to their behaviour, and therefore also constituting potential behavioural risks in relation to corporate governance. A question then arises as to how behavioural risks and personality risks in particular have been managed in corporate governance. Taking cognisance of the processes involved in risk identification and risk management, it is found that personality risks have not been identified by any corporate governance mechanisms, and which means, therefore, that these risks have not been managed effectively under any of the existing corporate governance mechanisms,

such as the Turnbull Guidance, UK Corporate Governance Code, UK Companies Act, and EU Company Law Directives. This also indicates that behavioural risks have been insufficiently managed because there cannot be an effective behavioural risk management process without an effective personality risk management process.

Considering the negative economic and social impact of corporate failures in relation to public listed companies, which includes capital and job losses, loss of confidence in capitalism, reduced markets for goods and services; and the justification for the State to intervene in order to safeguard society from the occurrence and consequences of these failures, this thesis suggests a hybrid regulatory model as an approach to managing personality risks in corporate governance and as part of the corporate governance process. Building upon relevant corporate and regulatory theories; and incorporating current realities as they relate to the regulation of companies, such as the popularity and flexibility of self-regulation; the thesis proposes a model with suggested provisions which are aimed at contributing to an effective outcome as regards personality risk management. The fundamental requirements of an effective risk management process are discussed and engaged with in the process of developing a conceptual framework for personality risk management from which the approach and provisions in the suggested model are drawn. The hybrid model consists of hard law provisions in the areas where they are deemed most essential in order to create effectiveness and soft law provisions in the areas in which it is thought that flexibility is necessary and would not negate the overall aims of the model.

CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

BACKGROUND

Corporate governance as a concept has become increasingly prominent due to the occurrence of high profile corporate failures.¹ Some of these failures resulted in negative consequences such as capital and job losses which affected the economic and social welfare of society.² It became important, therefore, to increase the focus on corporate governance because it is recognised as a mechanism which contributes to the prevention of corporate failures.³ From the era of the major corporate failures in the United Kingdom (UK) around the early 1990s to the corporate scandals in the United States (US) a decade later, efforts have been made by governments and business communities to improve corporate governance mechanisms in order to help prevent corporate failures.⁴ Reforms have taken the shape of promulgating principles of best practice in the UK and statutory intervention in the US.⁵ In the UK in particular, committees have been set up to examine corporate governance issues and develop mechanisms geared towards increasing the effectiveness of corporate governance.⁶ An examination of high profile corporate failures which have occurred in the last two decades

¹ The report issued by The Committee on the Financial Aspects of Corporate Governance (The Cadbury Report) in 1992 highlighted that corporate governance became a prominent issue on the public agenda in the United Kingdom following concerns over the BCCI and Maxwell Group corporate failures. See M.B. Hemraj, 'Preventing Corporate Failure: The Cadbury Committee's Corporate Governance Report' (2003) 10(2) *Journal of Financial Crime* 141-145. In the United States, the Enron failure drew enormous attention to corporate governance issues; see the numerous articles relating to the scandal at http://www.businessweek.com/magazine/toc/02_04/B3767enron.htm (accessed 15th June 2012).

² See R. Wearing, *Cases in Corporate Governance* (London: Sage Publications 2005). Some corporate failures could result in positive outcomes such as the promotion of competition and innovation, as well as the provision of learning opportunities which could enhance the potential for success in other endeavours, see A.M. Knott & H.E. Posen, 'Is Failure Good?' (2005) 26(7) *Strategic Management Journal* 617-641; see also B. Kriegesmann, T. Kley & M.G. Schwering, 'Creative Errors and Heroic Failures: Capturing their Innovative Potential' (2005) 26(3) *Journal of Business Strategy* 57-63. However, the corporate failures which result in mostly negative outcomes are worrisome, particularly when they are preventable.

³ See The Cadbury Report, (note 1) para 1.9.

⁴ For instance, the first UK corporate governance code was promulgated by The Cadbury Committee in 1992, whilst the Enron failure in the US, as well as that of WorldCom which occurred shortly after, necessitated the promulgation of the Sarbanes-Oxley Act in 2002.

⁵ Ibid.

⁶ Examples include the Cadbury (1992), Greenbury (1995), Hampel (1998) and Turnbull (1999 & 2005) committees and reports; see I.W. Jones & M.G. Pollitt, 'Understanding How Issues in Corporate Governance Develop: Cadbury Report to Higgs Review' (2004) 12(2) *Corporate Governance: An International Review* 162-171.

illustrates that inappropriate behaviour by company directors contributed to some of these failures.⁷ Companies are essentially managed by corporate officers, company directors being the principal officers provided for under the law.⁸ Therefore, management functions in companies are usually undertaken or authorised by company directors and managing companies effectively in order to prevent corporate failures is their responsibility.

Corporate failures can occur for a number of reasons,⁹ but of particular concern in this thesis are those failures in which a contributory component is the inappropriate behaviour of company directors. Despite the numerous corporate governance reforms that have taken place, corporate failures attributable to behavioural issues are still occurring. In the reports that followed investigations after the 2008/2009 financial crisis, it was clearly identified that the behaviour of company directors is a problem in corporate governance.¹⁰ These reports acknowledged, as had been evident in some of the corporate failures of previous years, that behavioural issues associated with company directors were a major contributory element in some recent corporate failures and the resulting financial crisis.¹¹ Behavioural issues can, therefore, be viewed as risks to the corporate governance process, and these risks are significant because they have the potential to result in corporate failures.¹² Questions then

⁷ Some of these corporate failures are examined in detail in chapter four. The issues which contributed to the failures in companies such as Maxwell Group, Enron, WorldCom, BCCI, were related in one way or another to the behaviour of company directors. See Wearing, (note 2).

⁸ The UK Companies Act 2006 in s 20 provides for the adoption of a Model Articles of Association for private limited companies and public companies, and the Model Articles specifies in Art 3 that subject to the Articles of Association, the directors are responsible for the management of the company. Art 5 specifies that company directors may delegate their powers and duties.

⁹ For instance the OECD highlighted various reasons for the recent corporate failures and financial crisis, including corporate risk management and board behaviour, see OECD Observer No 273, June 2009; see also G. Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis' (2009 *OECD Financial Market Trends*; see also The Turner Review: *A Regulatory Response to the Global Banking Crisis*, March 2009, at http://www.fsa.gov.uk/pubs/other/turner_review.pdf (accessed 15th June 2012).

¹⁰ See Annex 4 of the Walker Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations, 26th November 2009 at s 1.10, p 26 where reference is made, in relation to the causes of the financial crisis, to the fact that even though there were material deficiencies in financial regulation and prudential oversight, there were also material deficiencies in the effectiveness and oversight of company boards. The effectiveness and oversight of company directors are issues which are connected with their behaviour. The Institute of Chartered Secretaries and Administrators (ICSA) in their report in 2009 highlighted that the effectiveness of corporate governance systems is undermined by inappropriate boardroom behaviours. The OECD Steering Group on Corporate Governance also issued a report on the financial crisis in 2009, and one of the aspects identified as needing urgent attention was the performance of company directors, an issue which relates to their behaviour. These reports and others are discussed in more detail in chapter four.

¹¹ Ibid.

¹² Ibid, these reports identify behavioural issues as a contributory element to the corporate failures which led to the financial crisis. The meaning ascribed to "corporate failures" is as discussed in the section on definitions. Risk as a concept is generally understood as the possibility or potential of a negative outcome, and corporate failure can be described as one. Detailed discussions on risk are undertaken in chapter three.

arise as to whether existing corporate governance mechanisms have taken cognisance of the significance of behavioural risks; whether there are processes in place to manage such risks, and how effective these mechanisms are in relation to these risks? In answering these questions, it becomes pertinent to investigate what contributes to the creation and continued existence of behavioural risks, as that would be the starting point in managing such risks. An analysis of literature indicates that two components, personality and situations, are vital elements in relation to behaviour.¹³ Therefore, if a corporate governance system does not include mechanisms which identify these components of behavioural risks, and there are no processes in place to sufficiently manage the risks which accrue from each of the components and which in turn make up the totality of what behavioural risks entail, then a gap exists in relation to those unmanaged risks and the system is flawed to that extent.

THE AIMS OF THE RESEARCH

The purposes of this thesis are, firstly, to ascertain whether and how behavioural issues contribute risks to the effective operation of corporate governance processes and how these risks are identified and managed. In so doing, the thesis seeks to identify the elements which constitute behaviour, as those would be essential in the determination of whether behavioural risks are being managed effectively. Personality and situations are identified as the major elements of behaviour and the thesis then particularly investigates and focuses on personality as a significant contributory element to behaviour, and seeks to ascertain whether personality risks are effectively managed in corporate governance. Upon the examination of risk management mechanisms in corporate governance, it is found that personality risks are not identified and managed. This situation is argued to contribute to the insufficient and ineffective management of behavioural risks in corporate governance. Arguments are presented regarding the need to manage personality risks, highlighting the existence and negative implications of these risks as evidenced by the corporate failures which have occurred as a result of behavioural issues.

¹³ See D. Schultz & S.E. Schultz, *Theories of Personality* (5th ed., Pacific Grove, CT: Books/Cole Publishing 1994) 195; see also D.C. Funder, 'Personality, Situations and Person-Situation Interactions' in O.P. John, R. W. Robins & L.A. Pervin (eds.), *Handbook of Personality Theory and Research* (New York: The Guilford Press 2008) 568-581; In some of the examples of corporate failures discussed in chapter four, such as Maxwell Group, WorldCom and RBS, there were indications that the personality of the corporate officers were inappropriate and thus contributed to their inappropriate behaviour. Chapter five discusses personality and behaviour in detail.

Secondly, this thesis aims to determine what should be achieved as regards the effective management of personality risks and makes suggestions in a conceptual framework of approaches which can be adopted towards attaining this goal. Considering corporate and regulatory theories, and taking cognisance of the role of the State in the management of public listed companies, arguments are made for the adoption of a regulatory model to be utilised in the management of personality risks and in turn behavioural risks associated with company directors. There are also suggestions for provisions to be included in this model. This thesis contributes to the literature by addressing the issue of personality risks in corporate governance, highlighting the significance of personality risks and the linkage between personality and behaviour as far as corporate governance risks are concerned, illustrating that corporate governance mechanisms have largely ignored the personality aspect of behavioural risks, presenting a conceptual framework for personality risk management, arguing for statutory intervention in the management of behavioural risks, and developing a regulatory model for that purpose. All of the above contributions are aimed at improving the effectiveness of corporate governance by increasing knowledge and offering solutions which could influence policy in an area which might otherwise remain ignored despite its significance, and ultimately contribute towards a reduction in corporate failures attributable to behavioural issues.

The main proposition which this thesis seeks to address is ascertaining whether behavioural issues are risk contributors to the corporate governance process, and, if behavioural risks and personality risks in particular are routinely identified and managed effectively by existing corporate governance mechanisms, and if not, to ascertain an effective means of doing so, particularly in relation to company directors. In order to address the main proposition, the following sub-questions are considered and addressed:

- Are corporate failures attributable to the behaviour of company directors?
- Does the behaviour of company directors constitute risk in the corporate governance process?
- What constitutes behavioural risk?
- Is behavioural risk properly identified considering all it entails?
- Is behavioural risk effectively managed in corporate governance?
- Is personality a significant aspect of behaviour and what is the linkage?
- What constitutes personality and personality risk?
- Is personality risk effectively managed in corporate governance?
- Why is it important to manage personality risk?
- How can personality risk be managed effectively?

- Which approaches/mechanisms would meet the criteria for effectiveness?
- Why is a regulatory framework a good option for managing personality risks associated with company directors and how would it work?

JUSTIFICATION FOR THE RESEARCH

The recurrence of corporate failures apparently attributable to behavioural issues is such that there should be concerted efforts towards understanding the reasons for these failures, as this is a foundational step in the quest to find a meaningful solution to the problems associated with those issues. The enhancement of knowledge regarding personality risks and its impact on behavioural risks would contribute to an in-depth awareness of the problems which can arise in cases where personality risks are unmanaged. This knowledge also aids the development of effective risk management mechanisms in that regard. Considering the processes which are involved in risk management, developing a conceptual framework for personality risk management would afford detailed insight into the issues involved in the process and from which beneficial knowledge can be drawn in relation to developing effective risk management models. Flowing from an understanding of the underlying issues in relation to personality risks and behavioural risks, and taking cognisance of relevant factors, developing a personality risk management model for company directors is one means of contributing to the efforts being made to help in the prevention of corporate failures. These efforts are particularly justified considering the negative consequences of corporate failures such as economic and social losses, loss of lives and property, financial crisis, credit crunch and recession.¹⁴

SCOPE OF THE RESEARCH

This thesis focuses on behavioural risks as they relate to company directors. This is because company directors are the most identifiable set of corporate officers as their role is provided for under the law and the management of the company is particularly their responsibility.¹⁵ A company may elect not to have any other corporate officers other than directors, and the directors would end up as the only persons who are involved in the management of the company. There is, therefore, better clarity in focusing on company directors as the corporate officers primarily recognised by law under Article 3 of the Model Articles of Association provided for by section 20 of the UK Companies Act 2006.

¹⁴ The examples of corporate failures discussed in chapter four highlights these significant losses.

¹⁵ See The UK Companies Act and Model Articles, (note 8).

The thesis also restricts its analysis and solutions to public listed companies. This is because, as highlighted earlier, corporate governance became an issue predominantly as a result of failures in public listed companies, as these failures had negative impacts on society. Essentially, the quest to improve corporate governance originates from the desire to improve the management of companies on behalf of their shareholders and stakeholders who are usually absent from the management function. As much as privately held companies can benefit from corporate governance reforms which promote effective governance of companies generally, the focus of corporate governance mechanisms has largely been on public listed companies, one of the reasons being the separation of ownership from control.¹⁶ Corporate governance codes also usually operate under the auspices of stock exchanges, which supports the fact that code provisions are focused primarily on publicly traded companies.¹⁷ Therefore, the issues which necessitated the arguments and discussions in this research originate and relate to public listed companies, and so the solutions that are suggested here are also focused on such companies.

Again, the justification to develop mechanisms which would help prevent corporate failures is higher when the failures in question have adverse effects on society as a whole, which is the case when publicly traded companies fail. Some private companies no doubt impact on the wider society as well in terms of their activities, but nevertheless, their shares are not publicly traded and losses are usually restricted to the private owners save as it relates to the services which the company rendered to the public. Public listed companies offer their shares to the public, and so society has a broader interest in these companies as numerous people could invest in the companies and losses from their failures would affect more people. This thesis focuses on risk as it relates to corporate governance. It is acknowledged that the term “risk” might be interpreted in varying ways in different contexts, but the context in which it is utilised here is as discussed in chapter three, section 3.2. Risks have been viewed in corporate governance as events or issues which impact on the achievement of corporate

¹⁶ See para 3.1 of the Cadbury Committee Code 1992, which states that the code is directed to the boards of directors of all listed companies, even though all other companies are encouraged to meet its requirements. The UK Corporate Governance Code 2010 also states in its preamble that corporate governance is concerned with what the board of directors do and how they set the values of the company. The new code also states that it is applicable to listed companies. There is usually a separation of ownership from control in listed companies as shareholders may change over time and directors are appointed to manage the affairs of the company, see J.W. Salacuse, ‘Corporate Governance in the New Century (2004) 25(3) *Company Lawyer* 69-83 at 70; see also W. Bratton, ‘Berle and Means Reconsidered at the Century’s Turn’ (2001) Spring Edition *The Journal of Corporation Law* 753-762.

¹⁷ See for instance para 9.8.6 of the UK Listing Rules, which requires listed companies to report on whether or not they have complied with the Combined Code.

objectives. It is in this context that personality risks and behavioural risks are understood and analysed.

The jurisdiction of focus in this thesis is the UK. The thesis is concerned with UK corporate governance processes. In some cases, examples have been drawn from other jurisdictions with the aim of illustrating how widespread an issue is or to examine how an issue has been approached in another location. However, due to time and space constraints, as well as for the sake of familiarity, the major corporate governance mechanisms and corporate laws which are analysed in this research are those which are operational in the UK, and the solutions proffered here also adopt the UK corporate and regulatory foundations as the basis for their development.

OVERVIEW OF THE THESIS

This thesis is structured as follows:

Chapter One contains this introductory section, as well as the section which discusses the methodology adopted in the thesis. It also contains a section which defines the significant terms used in the thesis and explains their meaning in the context of the research.

Chapter Two is a review of the literature which forms the foundational and theoretical basis for the research. It contains discussions on literature relating to corporate theories, corporate governance, company directors, corporate failures, personality and behaviour, corporate risk management, and regulatory theories. This literature highlights the relevant developments in those areas and provides an understanding of the issues from which the research questions emerge. The chapter also provides an underlying basis for the arguments that emerge in the thesis and presents the perspectives from which solutions to the problems identified in the thesis are drawn.

Chapter Three examines the concept of risk and situates risk in the context of corporate governance. This chapter starts by presenting different definitions of risk and highlights the importance of risk management. It goes on to discuss how risk has been approached in corporate governance terms, beginning with the Turnbull Guidance which was issued by the Turnbull Committee after examining internal control and risk management practices in companies. The chapter also evaluates how personality risk and behavioural risk has been addressed by other corporate governance mechanisms such as the UK Corporate Governance Code, Company Law provisions, EU Regulations, and Financial Services Authority (FSA)

Approved Persons Regime which is applicable to companies operating in the financial services sector. Based on these discussions, arguments are made that personality risk should constitute a distinct and significant risk category. The chapter then highlights the lacuna in the risk management process as it relates to corporate governance by illustrating that personality risk has not been explicitly identified or provided for under existing corporate governance mechanisms. It is also argued that behavioural risks have been managed mostly from a “situational” perspective, as contrasted with a “person centred” perspective, and that ignoring the personality aspect of behavioural risks contributes to overall ineffectiveness in the management of behavioural risks as well as all other corporate risks.

Chapter Four discusses investigations into high profile corporate failures and the investigative reports issued after such failures with the aim of highlighting that behavioural issues have been recognised as a significant problem in corporate governance. For a practical perspective, and to situate the problem in the context of real experiences, the chapter then discusses some examples of corporate failures, highlighting specific behavioural issues which were contributory elements to those failures and illustrating the effects of the failures. There are discussions on personality and behavioural issues, indicating the linkage between these concepts as evident in the reports and examples of corporate failures. Arguments are then made regarding the negative impact of corporate failures and the need, as well as the justification, to seek solutions to the problem of personality risks. This chapter particularly illustrates the significance of personality and behaviour in relation to corporate failures and provides the foundation for the next chapter which seeks to establish a detailed understanding of personality and its impact on behaviour.

Chapter Five considers psychological literature and examines personality and its impact on behaviour. The chapter explains the meaning of personality; discusses the most widely accepted means of personality classification and identification, the Five-Factor Model and the NEO PI-R; examines the personality dimensions and their relationship to corporate governance in terms of leadership and performance roles; and presents arguments regarding the personality dimensions best suited to corporate governance. In discussing the different dimensions of personality and their potential behavioural tendencies, as well as the impact of personality on behaviour, this chapter emphasises the risks which emanate from personality issues and the importance and necessity of personality risk management.

Chapter Six presents a conceptual framework for personality risk management. The chapter begins with a discussion on what should be achieved in the management of personality risks. It then proceeds by discussing possible approaches to achieve this aim. There follows a discussion of the indicators of effectiveness as far as the risk management process is concerned. The chapter then argues that regulatory intervention in the form of a hybrid mechanism is an effective approach towards personality risk management. In order to provide a foundation for understanding why this approach is considered appropriate, there is a discussion of corporate and regulatory theories. Flowing from this, there follows a discussion of and justification for the particular regulatory approach adopted in the model, indicating its desirability, necessity, modality and acceptability. The chapter concludes with a discussion on the aims of the proposed model and the reasons why the approach taken achieves those aims.

Chapter Seven presents the regulatory model suggested as a means of engaging with the problems of personality risks and behavioural risks, a mechanism designed to manage personality risks in corporate governance. The chapter starts with a review of existing mechanisms and assesses the extent to which they are deficient in managing personality risks. There follows a more detailed discussion of the possible approaches to achieving the aims of the model, with indications as to the limitations in each approach. The chapter then discusses justifications for the hybrid regulatory approach from the perspective of regulatory theories, current trends and cost issues. There follows an illustration of the hybrid framework and the processes it entails. The chapter then goes on to discuss the model in detail, starting with its applicability, timing, procedure, monitoring, external authority and recommended provisions. There is a discussion of how the provisions of the model compare with the provisions relating to personality risk in the present UK corporate governance framework, particularly the FSA Approved Persons Regime and the Companies Act 2006. This is to further highlight the necessity for the model in the light of limitations and inadequacies of other existing mechanisms. There is also a discussion on the practical importation of the model into the UK corporate governance framework, as well as other considerations in relation to the model such as the most appropriate personality dimensions recommended for corporate governance, data protection and privacy implications and regulatory impact assessment issues. Finally, there is a presentation of a skeletal framework of what the model might appear like in the case that a new statutory instrument is sought, and this framework is presented as a means of contextualising the provisions suggested for inclusion in the model.

Chapter Eight concludes the thesis by presenting an overview of the core arguments and advances it has achieved. It also makes recommendations for further studies and development.

CORE ARGUMENTS IN THE THESIS

The major arguments in this thesis are as follows:

- 1) Corporate failures can occur as a result of, or be significantly contributed towards by behavioural issues relating to company directors, and therefore behavioural issues constitute risks to be addressed by corporate governance processes and mechanisms.
- 2) Personality is identified as an element in relation to behaviour and so behaviour cannot be adequately understood without an understanding of personality.
- 3) The relationship between personality and behaviour implies that personality risks contribute to behavioural risks, and so the management of behavioural risks will be insufficient if personality risks are not managed.
- 4) Corporate governance risk management processes as evidenced from the Turnbull Guidance and other relevant laws and regulations have failed to adequately identify personality risk as a distinct risk category, and there is no mechanism in place to specifically manage personality risks.
- 5) Personality risks, and in turn behavioural risks, are considered to be a problematic area in corporate governance as evidenced from investigations and reports on corporate failures. Practical examples as highlighted by the specific behaviour of company directors in the corporate failures discussed in the thesis also illustrate how behaviour can contribute to failures and how personality can impact on behaviour.
- 6) Evidence from psychological literature indicates that personality is a significant element in the constitution of behaviour; and that even in varying situations, outcomes still depend mostly on personality dimensions. This means that an individual's behaviour is largely dependent on his/her personality.
- 7) Personality dimensions are identifiable based on the prevalence of occurrence of particular traits, and these can be measured using some established methods in psychology. Likewise, there is evidence that certain personality dimensions are better suited to corporate governance.

- 8) In order to manage personality risks effectively, a conceptual framework would entail examining all the factors which would enable the achievement of the desired aim. In designing an appropriate mechanism, regard must be had to corporate theories as they provide the basis for understanding how companies exist and function. Regard must also be had to regulatory theories as they provide the underlying foundation upon which regulatory interventions rest.
- 9) Considering corporate theories, the State can intervene in the governance of companies in order to enhance the effective functioning of markets and in the interests of the public. Regulatory intervention in the management of personality risks is argued as justifiable because its aim is to help protect society from corporate failures.
- 10) A regulatory model comprising hard law provisions in the areas in which they would prove most effective and soft law provisions in the areas in which flexibility is required is argued to be an effective means of managing personality risks.

In conclusion, these core arguments give an indication as to the questions which prompted the investigations in this thesis and the critical findings which developed these questions, as well as the basis upon which the solutions suggested for the perceived problem are drawn. The chapters are developed in accordance with these core arguments and they expand on the issues highlighted. Personality risk is significant as it contributes to overall behavioural risks in corporate governance, and could also affect the management of all other corporate risks because the ability to engage in risk management tasks is also dependent on the personality of the individuals involved in the risk management process. It is argued that the advancements in knowledge regarding personality risks and the regulatory model suggested in this thesis should influence policy interventions in this area of corporate governance, as the effective management of personality risks is one potential means of safeguarding society from corporate failures.

1.2 METHODOLOGY

RESEARCH PARADIGM

This thesis utilises various approaches due to the nature of the research problem and the suggested solutions. It is doctrinal and qualitative to the extent that the process adopted is one which selects existing legal doctrines and regulations, as well as relevant literature which is most applicable to the research problem and analyses them in relation to the manner in

which they influence the problem and the extent to which they have provided and can provide solutions to the problem.¹⁸ It employs traditional doctrinal research methodology in law by identifying and analysing relevant legislation, cases and secondary legal materials; as well as adopting the research methodology in the social sciences which develops from a review of relevant literature. This research qualifies as qualitative to the extent that it identifies a problem which has social implications, and develops arguments aimed at influencing policy and law reform in relation to the research problem.¹⁹ It is applied research as it investigates a situation, identifies a problem and aims to use the information derived to enhance a better understanding of the problem and influence policy considerations.²⁰ It is also descriptive, correlational and explanatory in the manner in which the research problem is approached, because it describes an existing situation, identifies a correlation between aspects of the problem and seeks to proffer explanations regarding the problem.²¹ The thesis adopts an unstructured qualitative approach as its fundamental aim is to ascertain and describe the existence and nature of a problem; analyse perspectives and attitudes surrounding it; employ qualitative variables in conceptualising the problem and proffered solutions; and its analysis is aimed at establishing the variation in the problem without necessarily quantifying it.²²

RESEARCH METHODS

The research methods adopted here are as follows:

An introductory narrative is given to provide a background to the problem which led to the research, the aims of the research, the scope and the justification for undertaking the research. These sections highlight the existence and impact of the problem, and provide a basis for understanding the solutions suggested. There is also an overview of the thesis, highlighting the structure and contents of each chapter, as well as a presentation of the core arguments in the thesis as an indication of the crux of the research. The introductory chapter also contains a section which explains the research methodology adopted, and a section which provides working definitions of the significant terms used in the thesis, as a means of enabling a clear

¹⁸ See I. Dobinson & F. Johns, 'Qualitative Legal Research' in M. McConville & W.H. Chui, *Research Methods for Law* (Edinburgh: Edinburgh University Press 2007) 40.

¹⁹ See Dobinson & Johns, *ibid*.

²⁰ See C. Dawson, *Practical Research Methods* (New Delhi: UBS Publishers' Distributors 2002); see also C. R. Kothari, *Research Methodology: Methods and Techniques* (New Delhi: Wiley Eastern Limited 1985); see also R. Kumar, *Research Methodology: A Step-by-Step Guide for Beginners* (3rd ed., London: Sage Publications 2011) 10.

²¹ See Kumar, *ibid* 11.

²² See Kumar, *ibid* 13.

understanding of the context of the thesis as a whole and situating its arguments. It is arguable that terms may be ascribed different meanings in different situations, so the section on definition helps to present the exact meaning of the terms used in this thesis.

A literature review is conducted to provide a foundation for understanding the issues engaged with in the thesis. An analysis of relevant literature enables an overview of the academic and policy origins, as well as contemporary approaches, to the perceived problem addressed by the thesis and the issues surrounding it. It also highlights the gaps which exist in corporate governance literature and policy in relation to the problem. The review is undertaken in a thematic manner, to enable a clearer understanding of each set of issues. These issues flow from the fundamental theories and basis upon which the problem arises to all the other issues which surround or impact on the problem and possible solutions. In the literature review, each theme leads into the next and graduates to the specific basis upon which the research question is formed and the solutions suggested. In relation to choice of literature, the aim was to highlight and analyse those pieces of literature which contribute to an adequate understanding of the issues raised in each section.

In the subsequent chapters, the issues which emanate from the research questions are analysed, with discussions on the meaning of the terms in question, how they relate to the problem, why they are an important aspect of the problem, and how they influence the solutions to the problem. The issues are discussed in this manner so as to enable a clearer understanding of the context in which they arise in the thesis and how they relate to the research problem. For example, the terms “risk” and “personality” are defined according to relevant literature and the context in which they are used is made evident in the analysis. Theoretical analysis was conducted on the underlying aspects of the thesis such as the origin and existence of companies, meaning of corporate governance, risk management and regulation. This was done by reviewing the relevant literature on those subjects. The aim was to establish a foundation upon which conceptual arguments could emerge surrounding the crux of the thesis.

The theoretical framework for the thesis is centred on the meaning and import of companies, corporate governance, corporate boards, corporate failure, risk and regulation. The conceptual framework is centred on the impact of behaviour on corporate failure, what constitutes behaviour, whether behavioural risks are identified and managed effectively, and if and how regulation can contribute to managing these risks. The establishment of a

theoretical framework by an analysis of relevant literature and observations regarding current trends in corporate governance serves as a guideline and enables the development of the conceptual framework which encompasses the research problem and solutions.

Reports of government established bodies and non-governmental groups on the issues which led to corporate failures were analysed with the aim of highlighting the extent to which the research problem has been viewed in those circles and to illustrate current attitudes towards the problem. Court cases and judgments arising out of corporate failures were also highlighted in order to evidence the seriousness of the problem and the judicial view taken of it. The court verdicts also indicate the practical aspects of the research problem and societal attitudes towards the problem. The current attitude towards the research problem forms a basis for arguments in support of the existence and impact of the problem and the necessity of the solutions suggested in the thesis. As the UK is part of the European Union (EU), the approaches to the research problem as viewed from an EU perspective are also analysed.

The examples of cases of corporate failures are used primarily in this thesis to explain the practical impact of behaviour as a contributory element in corporate failures. The high profile cases which occurred in the UK, US and Australia are selected because the reports of the failures are publicly available as they had huge negative impacts on society and were investigated in detail. Also, these cases illustrate the issue of corporate failures in public listed companies and this thesis focuses on such companies and argues for statutory regulatory intervention based on the effect of such failures on society. These cases, therefore, constitute direct examples of the problem in question. Again, these cases all occurred in jurisdictions with similar corporate law origins and foundation. These jurisdictions follow the philosophical underpinnings of the contractual theory of corporations and the free market ideology. This similarity is evident in the wording of the UK Companies Act (section 7 & 8), the Delaware General Corporations Law (section 101, 107 & 109) and the Australian Companies Act (section 17, 19, 22 & 23). The examples of corporate failures used are, therefore, relevant in highlighting the problems of personality risks and providing a basis for understanding the solutions suggested in the thesis. Adopting examples from jurisdictions outside the UK was also thought to be relevant and informative because corporate governance is increasingly a global phenomenon; and an increasing number of companies have cross listings in different jurisdictions. Therefore, even though the focus of the thesis is the UK, the examples used illustrate that issues of personality are indeed universal as rightly noted in the psychological literature.

Personality is essentially a psychological and physiological construct which has been predominantly researched in the field of psychology; therefore an in-depth analysis was conducted on relevant psychological literature in order to enable a clear understanding of the term “personality” and its impact on behaviour. The thesis aims to provide the linkage between personality and behaviour, and so there was an analysis of a body of literature in the discipline of psychology which establishes the relationship between these concepts. Behavioural issues are psychological and have been studied in that discipline, therefore, the foundational theories as well as contemporary thinking regarding behaviour and the factors which influence behaviour was obtained by analysing relevant literature in that field. This was also done to highlight the other variables which impact on behaviour, such as situations, and to analyse the dominance or not of one or the other, in an attempt to highlight the level of impact of each component on behaviour.

In developing the regulatory model for personality risk management, corporate theories, regulatory theories and risk management theories, as well as existing mechanisms were examined and discussed with a bid to highlighting arguments in favour and against a regulatory regime as suggested in the thesis. Based on existing models of regulation as a frame, an example of what the model might entail in terms of provisions was drawn up. The applicability of the model in the present UK corporate governance framework is also examined with a view to situating the model in the immediate infrastructure, considering the impact of change and its economic implications. This is aimed at making the model an attractive and immediately available mechanism and highlighting its compatibility with existing regimes as well as areas of differences, in order to show more clarity as to the added value of the model.

In terms of accessing literature, searches were made in legal, social sciences and psychology databases, selecting literature which appeared to be seminal works, authoritative journal articles and books relevant to the research issues. In conducting the searches, key words, phrases and terms were developed from the major themes in the thesis, such as “causes of corporate failure”, “behaviour”, “personality”, “personality and behaviour”, “company agents”, “company directors”, “corporate officers”, “corporate governance”, “risk”, “risk management”, “corporate failure”, “regulating companies”, “corporate theories”, and were used both singly and in conjunction with the secondary themes in the thesis to enable an identification of relevant literature. The items of literature which are then selected are the ones which enable an adequate understanding of the perspectives being proffered in the

thesis, and without which the arguments and the developments in the thesis would be incoherent.

Government databases in the UK and the EU were also searched in order to obtain reports and current regulations on the relevant issues in the thesis. The internet was searched for current and contemporary debates, information and materials on the issues. This information was then reviewed with a focus on relevance, authenticity and authoritativeness. Literature, regulations and policy developments were then analysed in the light of the research issues. The suggestions outlined in the thesis are based on highlighted limitations in existing frameworks, and takes cognisance of fundamental corporate and regulatory theories, the general idea being to build on a firm and established foundation. The thesis finishes with a conclusion which highlights the import of the thesis as a whole, reiterating its major arguments and advances. This section also highlights areas in which the findings of the thesis can prove useful and suggests areas of further research with the aim of aiding continuity in the expansion of knowledge and development of other aspects which might correlate with the research problem and the solutions offered.

1.3 DEFINITIONAL ISSUES

This section provides clarification as to the meaning ascribed to the major terms used in the thesis so as to aid an understanding of the context in which they are utilised.

PERSONALITY: This refers to that innate aspect of individuality which has an impact on behaviour and is as explained in chapter five.

RISK: This means the potential of an event or circumstance resulting in a negative outcome, and is as explained in chapter three.

BEHAVIOUR: This refers to actions and decisions taken in the corporate governance process by company directors.

COMPANY DIRECTORS: This refers to the persons saddled with the responsibility of company management as specified under Article 3 of the Model Articles and the UK Companies Act 2006.

COMPANY AGENTS: This is used to refer to company directors in relation to the agency relationship existing between the company directors and the company as represented by its shareholders.

COMPANY: In accordance with the provisions of the UK Companies Act 2006, a company is one which is formed and registered under the provisions of the Act. This thesis is particularly focused on public listed companies.

CORPORATE FAILURE: This term refers to both an outright collapse of a company in terms of insolvency, as well as a collapse of systems of corporate governance within the company such as non-compliance with rules and regulations and non-attainment of corporate goals.

REGULATION: This refers to rules and recommendations designed to control the conduct of the regulated, and include both statutory and non-statutory provisions.

SIGNIFICANT: This is as defined ordinarily to connote a situation that is meaningful and likely to have an effect.

RISK MANAGEMENT: This is as explained in chapter three in relation to the identification and mitigation of risks.

SOFT LAW: This refers to flexible and non-mandatory regulation.

HARD LAW: This refers to mandatory and prescriptive regulation.

CHAPTER TWO

A REVIEW OF RELEVANT LITERATURE

2.1 INTRODUCTION

Chapter one provided the background for an understanding of the origin of the issues discussed in this thesis. It also outlined the major arguments made in the thesis in relation to the problem of personality and behavioural risk in corporate governance, and the solutions suggested for addressing the problem. To further enhance an understanding of the problem and solutions, this chapter reviews the relevant literature in the areas which form the foundational basis for the thesis, and from which theoretical and conceptual arguments are drawn. The review highlights and discusses relevant literature in the areas of corporate theory, corporate governance, corporate boards and directors, corporate failures, personality and behaviour, corporate risk and risk management, and regulation.

2.2 CORPORATE THEORIES

The origin, existence and functionality of companies can be explained by corporate theories.²³ An adequate understanding of the issues regarding the formation, management and operations of companies cannot be achieved without knowledge of relevant corporate theories. Engaging with different corporate theories provides the basis for a broad understanding of what companies are and enables an identification of the theories which underpin various perspectives on corporate governance.²⁴ Understanding the philosophical underpinnings of corporate theories also aids the advancement of arguments for and against the utility of those theories, and provides a platform for the analysis of problems and solutions in relation to the functioning of companies based on those theories. Particularly, in order to appreciate the problem highlighted in the thesis and understand the rationale behind the solutions suggested, as well as assess the suitability and effectiveness of these solutions, it is important to ascertain what companies are, how they are viewed, and enable an

²³ See D. Kantarelis, *Theories of the Firm* (2nd ed., Geneve: Inderscience 2007); see also O. Hart & J. Moore, 'Property Rights and the Nature of the Firm' (1990) 98 *Journal of Political Economy* 1119-1158; see also M.C. Jensen, *A Theory of the Firm: Governance, Residual Claims and Organisational Forms* (Cambridge, MA: Harvard University Press 2000); see also A. Belcher, 'The Boundaries of the Firm: the Theories of Coase, Knight and Weitzman' (1997) 17(1) *Legal Studies* 22-39.

²⁴ See S. Turnbull, 'Corporate Governance: Theories, Challenges and Paradigms' (2000) 1(1) *Gouvernance: Revue Internationale* 11-43; see also T. Clarke (ed.), *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance* (London and New York: Routledge 2004).

understanding of how and why they function the way they do. A discussion of corporate theories is therefore essential to achieving these aims.

Coase's theory of the firm ascribes the reason for the existence of the firm to the fact that an entrepreneur cannot own all the factors of production, and were these factors to be sought outside the architecture of a firm, the entrepreneur would need to engage in a series of contracts which would invariably result in high transaction costs.²⁵ Therefore, where the contract between the entrepreneur and the factors of production is on-going, in order to minimize the transaction costs of the economic activity, there is a preference for a single long-term contract in which the entrepreneur assumes a hierarchical role and obtains the cooperation of the other factors of production subject to remuneration.²⁶ Coase's theory is one which is rooted in the notion that the different factors of production have property rights which they exercise contractually as constituents within the firm.²⁷ He argued that firms provided an avenue for the entrepreneur to utilise direct authority in effecting exchanges in cases where the cost of so doing in the markets was higher. The firm is therefore set up to maximise the economic welfare of the constituents.

Alchian & Demsetz²⁸ refine Coase's theory to the extent that they highlight the voluntariness of the contract between the constituents of the firm and suggest that the firm is actually a portal for team production. They also emphasize the need for monitoring the constituents of the firm in order to deter the shirking of responsibilities within the team. Whereas Coase argued that the firm exists to achieve the allocation of resources by authority and direction, Alchian & Demsetz view the firm as a mechanism which originates and exists based on joint efforts. They define the firm as a contractual organisation of inputs in which there exist (i) joint input production (ii) several input owners (iii) one party who is common to all the contracts (iv) the common party having rights to renegotiate the contract of an input independent of other contracts (v) the common party holding the residual claim (vi) the common party having the right to sell his residual status. However, in agreement with Coase, Alchian & Demsetz view the firm essentially from an economic and contractual perspective. Therefore, the firm exists to meet economic ends.

²⁵ See R.H. Coase, 'The Nature of the Firm' (1937) *Economica* 386-405.

²⁶ See Coase, *Ibid* 390-393.

²⁷ See also E.G. Furobotn & S. Pejovich, 'Property Rights and Economic Theory: A Survey of Recent Literature' (1972) *X Journal of Economic Literature* 1137-1162.

²⁸ See A. Alchian & H. Demsetz, 'Production, Information Costs and Economic Organisation' (1972) *LXII (5) American Economic Review* 777-795.

Jensen & Meckling²⁹ explain that the firm is in itself a mere legal fiction and simply serves as a nexus for contracting relationships.³⁰ They argue that the firm is characterized by divisible residual claims on the assets and cash flows of the organisation which can be sold without the permission of other contracting individuals. They acknowledge that their definition of the firm has minimal substantive content but rather emphasises the contractual nature of the firm.³¹ They also highlight that there are problems of agency and monitoring costs for these contracts which exist in the firm irrespective of the form of the contracts. Berle & Means³² had highlighted the agency problems which resulted in cases where share ownership was dispersed and ownership of a corporation was separated from control of it. Jensen & Meckling acknowledge this problem and define agency as “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent”.³³ They argue that most agency relationships will incur monitoring and bonding costs as well as residual loss arising from the possibility of divergent interests between the principal and the agent. Jensen & Meckling go on to argue that the relationship between shareholders and company managers is purely one of agency and so the separation of ownership and control would invariably create agency problems.³⁴ They also draw a relationship between agency costs and a theory of firm ownership.

Fama & Jensen³⁵ highlight that social and economic activities can be carried out by different forms of organisations and argue that an important factor in the survival of organisational forms is the control of agency problems because the organisation that succeeds most is the one that delivers goods and services to the consumers at the lowest price whilst covering its cost. Departing from the dominant contractual view of the firm, Rajan & Zingales³⁶ define the firm as a nexus of specific investments, highlighting the need for the specialised skills of

²⁹ See M. Jensen & W. Meckling, ‘Theory of the Firm, Managerial Behaviour, Agency Costs and Ownership Structure’ (1976) 3(4) *Journal of Financial Economics* 305-360.

³⁰ See also F.H. Easterbrook & D. R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press 1991).

³¹ See Coase, (note 25) and Alchian & Demsetz, (note 28); see also E.F. Fama, ‘Agency Problems and the Theory of the Firm’ (1980) 88 *Journal of Political Economy* 288-307.

³² See A. Berle & G. Means, *The Modern Corporation and Private Property* (New York: Macmillan 1932)

³³ See Jensen & Meckling, (note 29) 308.

³⁴ See also E. F. Fama & M.C. Jensen, ‘Separation of Ownership and Control’ (1983) 26 *Journal of Law and Economics* 301-325.

³⁵ See E.F. Fama & M.C. Jensen, ‘Agency Problems and Residual Claims’ (1983) 26 *Journal of Law and Economics* 327-349.

³⁶ See R.G. Rajan & L. Zingales, ‘Power in a Theory of the Firm’ (1998) *Quarterly Journal of Economics* 387

employees.³⁷ Here, the team production theory is employed as the contributors to the team production process relinquish control of their specific investments to an independent party in order to reduce transaction costs which they would otherwise incur if complete contracts were embarked upon *ex ante*.

The nexus of contract and the nexus of specific investment theories of the firm are essentially rooted in economic/finance literature, but there are also legal theories of the firm. Lan & Heracleous³⁸ outline the legal theories of the corporation and their stages of development; from the concession/fiction theory,³⁹ to the contractual/aggregate theory,⁴⁰ and to the realist/organic theory.⁴¹ The contractual theory of the firm has both legal and economic dimensions. The legal contractual theory posits that a company is simply the aggregate of two or more persons who unite in order to undertake commercial activity.⁴² This presupposes that the company is rooted in private contract law as the members are connected in the origin, existence and demise of the company by virtue of the contract which they enter into; and one implication of this theory is that a company is a creation of individual free will and therefore not subject to social responsibility.⁴³ Again, the company is placed under the sphere of private law with its legitimation powers originating from the entrepreneurial activities of the members and lessening any justification for State or public interference by way of regulation.⁴⁴

³⁷ See also M. Blair, 'Firm-Specific Human Capital and Theories of the Firm' in M. Blair and M. J. Roe (eds.) *Employees and Corporate Governance* (Washington DC: Brooking Institute 1999), who argues that the firm specific investments of employees cannot be adequately protected by means of contract and the firm is a relationship of trust.

³⁸ See L.L.Lan & L. Heracleous, 'Rethinking Agency Theory: The View from Law' (2010) 35(2) *Academy of Management Review* 294-314 at 295-296.

³⁹ The corporation is viewed as a legal fiction, a creature of the state and bound by its charter. See E. Latham, 'The Body Politic of the Corporation' in E. Mason (Ed), *The Corporation in Modern Society* (Cambridge MA: Harvard University Press 1959) 218-236.

⁴⁰ The corporation exists as a result of the voluntary contracts created by corporate constituents. See R. Kraakman, 'Corporate Liabilities Strategies and the Costs of Legal Controls' (1984) 93 *Yale Law Journal* 857-898

⁴¹ The corporation is a real entity, having separate personality and can be viewed as a social being. See M. Phillips, 'Reappraising the Real Entity Theory of the Corporation' (1994) 21 *Florida State University Law Review* 1061-1123.

⁴² See S. Bottomley, 'Taking Corporations Seriously: Some Consideration for Corporate Regulation' (1990) 19 *Federal Law Review* 208.

⁴³ See D. Sugarman & G. Rubin (eds.), *Law, Economy and Society, 1750-1914* (Abingdon: Professional Books 1984).

⁴⁴ See Sugarman & Rubin, *ibid* 209.

The economic contractual theory is based on the view that free markets are the most efficient mechanisms for wealth creation.⁴⁵ Economists such as Coase then view the company as a nexus of contracts entered into in order to reduce transaction costs of a complex market consisting of a series of bargains amongst parties and corporate law exists solely to provide bottom line rules which the entrepreneurs would have had to contract upon separately with their agents.⁴⁶ Corporate law, therefore, serves to simply enhance the basic functioning of the market. Jensen & Meckling theorized that the firm is simply a nexus of contracts, and argued that companies essentially serve as avenues for contracting relationships.⁴⁷ It has been argued that under the contractual theory, the law has minimal function beyond substantiation of contracts and legal rules merely spell out what the human aggregates would have agreed to in the first place.⁴⁸ The contractual theory “rests on notions of rationality, efficiency and information”, with the view that a rational person would enter into transactions which benefit him/her as well as society.⁴⁹ The contractual nature of the relationship between investors and managers is emphasised under the contractual theory, and this theory gained prominence after the era in which companies were created by specific State charters and authorised to operate solely for specified purposes.⁵⁰

The communitarian theory of the firm views the company purely as a creation of the State and to be utilized for State purposes, and therefore the company has no strong commercial identity and is more of a political tool.⁵¹ Companies modelled on this theory were common in the former communist countries and in fascist Italy.⁵² Here the State grants companies the right to function and also determines the extent to which they function. The goals and objectives of the company are set out by the State and are usually in furtherance of State will. Therefore regulation by the State is paramount and inevitable. The concession theory of the

⁴⁵ This was the argument made originally by Adam Smith. See A. Smith, *The Wealth of Nations* (London: J.M. Dent & Sons 1910).

⁴⁶ See Coase, (note 25).

⁴⁷ See Jensen & Meckling, (note 29).

⁴⁸ See Lan & Heracleous, (note 38) 296.

⁴⁹ See J. Dine, *The Governance of Corporate Groups* (Cambridge: Cambridge University Press 2000) 9.

⁵⁰ See H. Hansmann & R. Kraakman, ‘The End of History for Corporate Law’ (2001) 89 *Georgetown Law Journal* 439-468; see also M. Klausner, ‘The Contractarian Theory of Corporate Law: A Generation Later’ (2006) 31 *The Journal of Corporation Law* 782; see also D Millon, ‘Frontiers of Legal Thought I: Theories of the Corporation’ (1990) *Duke Law Journal* 201-262; see also J.J. Du Plessis, ‘Corporate Law and Corporate Governance Lessons from the Past: Ebbs and Flows, but Far from the End of History,,,’, Part 1 (2009) 30(2) *Company Lawyer* 43-51 at 45; see also H.N. Butler, ‘Nineteenth Century Jurisdictional Competition in the Granting of Corporate Privileges’ (1985) 14 *The Journal of Legal Studies* 129.

⁵¹ See Dine, (note 49) 17.

⁵² See P.J. Williamson, *Corporatism in Perspective: An Introductory Guide to Corporatist Theory* (London: Sage Publications 1989).

firm views the existence of the company as a concession granted by the State and regulatory intervention in the governance of companies is justified because the company is a legal creation whose existence derives from the State.⁵³ The concession theory differs from the communitarian theory to the extent that in the concession theory, the State only “has a role to play in ensuring that corporate governance structures are fair and democratic”, and the State does not aim to align the company’s goals with its social or political aspirations.⁵⁴ In the era when companies operated based on State charters, it was under the concession of the State; even though the companies at that time were restricted in their activities to those specified in the charter.⁵⁵ However, the concession theory as it is understood presently refers to the notion that the company is a creation of the State regardless of its objects, and exists to meet public needs; and flowing from the concession theory, the State has the right to impose regulations on companies based on public interest.⁵⁶

According to Dine, one important factor as regards the regulation imposed by the State under the concession theory would be the necessity of such regulations taking cognisance of the role of shareholders as owners; and preserving the rights which shareholders have to exercise in the bid to ensure that the company is well governed.⁵⁷ Dine argues that one vital question for the State would be whether shareholders are able to regulate the operations which the State is seeking to regulate. Understandably, if shareholders are able to achieve that which the State aims to achieve, then there may be no need for State intervention. Dine further argues that reliance on contractual theories of the firm would leave the society in a situation where shareholders are the sole guardians of public interest in corporate governance. But Dine adds that considering that one import of the idea of separate legal personality is to allow for separation of ownership and control, separation can become extreme in many cases so that shareholders are no longer an effective governance mechanism even as regards issues that directly concern them as owners. In truth, if shareholders are so dispersed that there is no opportunity and mechanism which enables a meaningful coalition in order to create an impact, then the utility of shareholder intervention as a mechanism in corporate governance becomes doubtful.

⁵³ See Lan & Heracleous, (note 38).

⁵⁴ See Dine, (note 49) 21.

⁵⁵ See Millon, (note 50).

⁵⁶ See Dine, (note 49) 29.

⁵⁷ See Dine, (note 49) 30-31; see also J. Solomon, *Corporate Governance and Accountability* (2nd ed., Chichester: Wiley & Sons 2007) 18 where it is argued that regulatory intervention which is not in the interest of shareholders may be viewed as undermining their proprietary rights and the important factor for shareholders is usually to exercise control over company management.

Dine concedes, and rightfully so, that it is much less likely that shareholders can be relied on to protect public interest when they have been ineffective in protecting theirs, because in reality, small investors are usually more interested in the return on their investment whilst institutional shareholders would rather adopt exit mechanisms rather than voice in companies that are underperforming.⁵⁸ Again, vital information is held in the hands of management, so, to depend on shareholders as an effective governance mechanism is essentially to allow directors and management free rein “subject to the unpredictable whims of the market for corporate control”.⁵⁹ This would prove to be true because if shareholders are not in effective control of companies, then the directors and managers who are involved in the actual running of the companies would be in a better position to navigate the companies towards the direction which accomplishes their own purposes, which may differ from that of the shareholders.

Recently, there has been an increased consideration of interests other than shareholder interests in companies.⁶⁰ Therefore, in relation to corporate matters, there are various interests involved.⁶¹ If shareholders cannot effectively protect their interest or that of others in corporate operations, then “some other system of regulation is clearly required”.⁶² This means that a departure from the purely contractual theory in which the shareholders are responsible for determining the terms of the corporate contract as well as its major governing rules and a move towards the concession theory in which State regulation is acceptable in the interest of the public as stakeholders in corporate operations, is a reasonably acceptable situation. An analysis of the corporate theories discussed above indicates that companies are essentially vehicles for economic enhancement and occupy an important place in society. Public listed companies, particularly, require adequate regulation for the reason that ownership is usually separated from control. As stated earlier, under the contractual theory of the firm, self-regulation is preferred and State intervention by way of regulation is acceptable only to the extent that it provides rules for the basic functioning of markets. It means that if an issue is viewed as contributing towards the functioning of markets, then regulation in that

⁵⁸ Ibid; see also R. Webb, M. Beck & R. McKinnon, ‘Problems and Limitations of Institutional Investor Participation in Corporate Governance’ (2003) 11(1) *Corporate Governance: An International Review* 65-73.

⁵⁹ See Dine, (note 49) 31.

⁶⁰ For instance, the Stakeholder interest theory posits that companies should take cognisance of the interests of stakeholders other than shareholders, such as employees, creditors, and society. See S. Gillan, ‘Recent Developments in Corporate Governance: An Overview’ (2006) 12 *Journal of Corporate Finance* 382; see also A.K. Sundaram & A.C Inkpen, ‘The Corporate Objective Revisited’ (2004) 15(3) *Organisation Science* 350-363.

⁶¹ See Lan & Heracleous, (note 38) 298.

⁶² See Dine, (note 49) 35.

regard is acceptable. The concession theory admits of regulation by the State in the public interest. The problem of personality risks in corporate governance is one that arises out of and affects the functioning of markets and is also an issue in the public interest as it has the potential to result in corporate failures. The solutions suggested in this thesis are based on arguments that both theories admit of regulatory intervention when the problem in issue affects the functioning of markets and is in the interests of society. The regulatory approach suggested in this thesis also takes cognisance of these theories by incorporating both soft law and hard law provisions. In relation to the substantive structure of the company, Hansmann & Kraakman⁶³ identify five characteristics of the company as follows: (i) legal personality, (ii) limited liability, (iii) transferable shares, (iv) centralised management under a board structure, and (v) shared ownership by contributors of capital. They argue that in most jurisdictions, corporate law statutes provide for the formation of firms with all of these characteristics. They also highlight the fact that these characteristics which make the company an attractive organisational form for economic activity also generate tensions and trade-offs which lend a corporate character to the agency problems which corporate law must address. The agency problem inherent in firms as a result of the separation of ownership from control is also the origin of corporate governance. The corporate theories discussed above influences the different perspectives on corporate governance as will be illustrated in the next section.

2.3 CORPORATE GOVERNANCE

The foundational description of corporate governance may be traced back to the separation of ownership and control theory propounded by Berle & Means.⁶⁴ The crux of their argument was that the agency problem which arose from the dispersion of share ownership resulted in owners not being able to monitor managers effectively in order to ensure adequate returns on their investment and the reduction of managerial appropriation.⁶⁵ A mechanism for mitigating agency problems therefore became imperative. Corporate governance is a multi-disciplinary and inter-disciplinary subject with its research cutting across major disciplines including law,

⁶³ See Hansmann & Kraakman, (note 50) 439; see also J. Armour, H. Hansmann & R. Kraakman, 'The Essential Elements of Corporate Law' (2009) *ECGI Working Paper No 134/2009*.

⁶⁴ See Berle & Means, (note 32); see also Salacuse, (note 16); see also R. Smerdon, *A Practical Guide to Corporate Governance* (2nd ed., London: Sweet & Maxwell 2004) 2 where it is stated that the term "corporate governance" has its roots from the American Law Journals.

⁶⁵ See F.H. Easterbrook, 'The Race for the Bottom in Corporate Governance' (2009) 95 *Virginia Law Review* 687; see also Bratton, (note 16).

economics, finance, management and accounting.⁶⁶ Some of the theories of governance that have emerged include the finance or shareholder model, stewardship or managerial model, and the stakeholder model.⁶⁷ Systems of governance have also been created based on characteristics such as the concept of the firm, the board system, the stakeholder exerting influence, the stock market in the economy, market for corporate control, ownership structure, executive compensation and time horizons of economic relationships.⁶⁸ Flowing from these different theories, models and systems of governance, significant differences can be noted between the perspectives on corporate governance held in Anglo-Saxon regions as compared with and between other regions such as Continental Europe, Latin America and Japan; creating divisions into “market oriented” systems and “network oriented” systems of corporate governance.⁶⁹ An examination of varying definitions of corporate governance tends to show that these definitions emanate predominantly from the particular model or theory of governance that exists in the mind of the definer, and these theories appear to be dependent on one’s idea of what corporate objectives should entail.⁷⁰

Shleifer & Vishny view corporate governance from an agency perspective and state that it “deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”; and they highlight that the subject of corporate governance is of enormous practical importance.⁷¹ The Cadbury Committee defined corporate governance as “the system by which companies are directed and controlled”,⁷² emphasizing the need for owners to devise mechanisms of exercising control over management. Blair views corporate governance as “the whole set of legal, cultural and

⁶⁶ See L. Bebchuk & M. Weisbach, ‘The State of Corporate Governance Research’ (November 2009), *Fisher College of Business Working Paper 2009-03-020*; see also B. Durisin & F. Puzone, ‘Maturation of Corporate Governance Research 1993-2007: An Assessment’ (2009) 17(3) *Corporate Governance: An International Review* 266; see also Gillan, (note 60) 382.

⁶⁷ See S. Turnbull, ‘Corporate Governance, Its Scope, Concerns and Theories’ (1997) 5(4) *Corporate Governance: An International Review* 180-181; see also S. Letza, X. Sun & J. Kirkbride, ‘Shareholding Versus Stakeholding: A Critical Review of Corporate Governance’ (2004) 12(3) *Corporate Governance: An International Review* 244; see also K. Keasey, S. Thompson & M. Wright, *Corporate Governance: Economic, Management and Financial Issues* (Oxford: Oxford University Press 1997) 3-10; see also M. Huse, *Board, Governance and Value Creation: The Human Side of Corporate Governance* (Cambridge: Cambridge University Press 2007) 18-23.

⁶⁸ See J. Weimer & J.C. Pape, ‘A Taxonomy of Systems of Corporate Governance’ (1999) 7(2) *Corporate Governance: An International Review* 161.

⁶⁹ See Weimer & Pape, *Ibid*; see also M.J. Roe, *Political Determinants of Corporate Governance: Political Context, Corporate Impact* (Oxford: Oxford University Press 2006) 204.

⁷⁰ See Letza, Sun & Kirkbride, (note 67).

⁷¹ See A. Shleifer & R. Vishny, ‘A Survey of Corporate Governance’ (1997) 52(2) *The Journal of Finance* 737-783 at 737.

⁷² See The Cadbury Report on the Financial Aspects of Corporate Governance published in December 1992, (para 2.5).

institutional arrangements that determine what public corporations can do, who controls them, how that control is exercised and how the risks and returns from the activities they undertake are allocated”,⁷³ an emphasis on public corporations being evident. Tirole argues that a good governance structure is one that selects the most able managers and makes them accountable to investors.⁷⁴ Tirole emphasises the importance of recruiting managers who are most capable of pursuing the investor’s objectives. Neubauer & Lank explain that corporate governance is a system of structures and processes to secure the economic viability as well as the legitimacy of the corporation.⁷⁵ In the UK, in the late 20th century, and particularly in the realm of finance, the shareholder theory of corporate governance has emerged as the dominant theory,⁷⁶ with the stakeholder theory emerging as the most definitive contrasting theory amongst the other variants of theories opposing the shareholder model. In essence, the shareholder theory is underpinned by an understanding of the corporation as an entity existing for the benefit of its owners and, therefore, all governance mechanisms should be geared towards the maximisation of shareholder value. The stakeholder theory on the other hand views the corporation as existing to serve much wider interests, including those of constituencies affected by its operations such as its employees, creditors, suppliers and the community.⁷⁷ It has been argued that the major divide between these theories originates from the fundamental corporate law mechanisms historically enshrined in different regions of the world.⁷⁸ There are also views that the agency problem would not appear in all cases because share ownership is not dispersed in every region of the world and in certain regions, Continental Europe being an example, ownership patterns are quite concentrated.⁷⁹

⁷³ See M. Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty First Century* (Washington DC: Brookings Institution 1995) 3.

⁷⁴ See J. Tirole, ‘Corporate Governance’ (2001) 69(1) *Econometrica* 1-35; see also M.R. Iskander & N. Chamliou, *Corporate Governance: A Framework for Implementation* (The World Bank Group 2000) 3 where it is argued that corporate governance became necessary as a result of the need to balance divergent interests because the objectives of the owners of a company can differ from those of the managers of that company and it is important to align these interests for the effective functioning of the company.

⁷⁵ See F.F. Neubauer & A.G. Lank, *The Family Business: Its Governance for Sustainability* (New York: Routledge 1998).

⁷⁶ See Sundaram & Inkpen, (note 60) 350; see also Letza, Sun & Kirkbride, (note 67) 244-245.

⁷⁷ See T. Donaldson & L. Preston, ‘The Stakeholder Theory of the Corporation-Concepts, Evidence and Implication’ (1995) 20(1) *Academic Management Review* 65-91; see also E.R. Freeman, A.C. Wicks & B. Parmar, ‘Stakeholder Theory and “The Corporate Objective Revisited”’ (2004) 15(3) *Organisation Science* 364-369.

⁷⁸ See R. La Porta, F. Lopez-de-Silanes, A. Shleifer & R. Vishny, ‘Investor Protection and Corporate Governance’ (2000) 58 *Journal of Financial Economics* 3-27; see also C.A. Mallin, *Corporate Governance* (2nd ed., Oxford: Oxford University Press 2007) 57 & 66.

⁷⁹ See R. La Porta, F. Lopez-de-Silanes & A. Shleifer, ‘Corporate Ownership around the World’, (1999) 54(2) *Journal of Finance* 471-517.

Corporate governance mechanisms have also been said to fall into one of two groups: those internal to firms and those external to firms and it is flowing from this grouping that internal actors and external actors emerge in relation to corporate governance.⁸⁰ Huse views corporate governance in this way and states that corporate governance is “the interaction between coalitions of internal actors, external actors and the board members in directing a corporation for value creation”.⁸¹ Internal actors are described as those who make decisions and take actions while external actors are those who seek to influence and control decisions.⁸² As noted earlier, there has never been a consensus definition of corporate governance and all that it entails. In fact, corporate governance has been described as a struggle between ideologies.⁸³ However, it can also be argued that regardless of whichever specific theory of governance is adopted, company managers will still need to be controlled in order to achieve whatever has been postulated as the chosen corporate objective, be it shareholder value maximisation or stakeholder interest. There may also be overlaps in both theories as is evident in some definitions of corporate governance, for instance, Monks & Minow view corporate governance as the relationship among various participants in determining the direction and performance of corporations. The primary participants are (i) the shareholders (ii) the management led by the CEO and (iii) the board of directors. Other participants include the employers, customers, suppliers, creditors and the community.⁸⁴ This perspective highlights the involvement of all known constituencies in the governance process, even though certain primary participants are named, giving an indication of the fact that those are the major players in the corporate governance chain.

The Organisation for Economic Co-Operation and Development (OECD) in its Principles of Corporate Governance (2004) states that “corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders”.⁸⁵ This inclusive definition incorporates both the shareholder and stakeholder theories and considering the events of the past decades in the area of corporate collapses, it is

⁸⁰ Jensen & Meckling argue that it makes no sense to distinguish between factors that are “inside” the firm from those that are “outside” it, because what exists is a multitude of complex contracts between the firm and the owners of labour, material and capital input and consumers of output. Nevertheless, from a corporate governance perspective, those distinctions have been argued. See Jensen & Meckling, (note 29); see also Gillan, (note 60) 382.

⁸¹ See Huse, (note 67) 4.

⁸² See Huse, *Ibid* 16.

⁸³ See Huse, *Ibid* 24.

⁸⁴ See R.A.G. Monks & N. Minow, *Watching the Watchers: Corporate Governance for the 21st Century* (Cambridge: Blackwell Publishers 1996).

⁸⁵ See the Preamble, OECD Principles of Corporate Governance, 2004 (p 11).

arguably worthwhile to adopt a definition of corporate governance which is all encompassing, taking into cognisance the needs of all the facets of a society affected by the activities of a company. However, considering the exertion of control and decision making within the company itself, certain constituencies may naturally have dominance, the obvious groups being the owners and managers of the company. Du Plessis highlights that the meaning of the term “corporate governance” has surprisingly not been given an in-depth interpretation, with most definitions just referring to the term generally without offering deeper clarification; and he argues that the preferred explanation of the term is that it is “the process of regulating and overseeing corporate conduct and of balancing the interest of all internal stakeholders and other parties who can be affected by the corporation’s conduct in order to ensure responsible behaviour by corporations and to achieve the maximum level of efficiency and profitability for a corporation”.⁸⁶

An analysis of the literature relating to the theories of governance and definitions of corporate governance highlights the diversity and multi-faceted nature of corporate governance both as a mechanism and as a broad concept. It also establishes that views on what amounts to “corporate governance” may differ considerably depending on one’s background and perception of the firm. However, it is clear on the basis of the preceding literature that one thread which runs through the entire range of governance theories and definitions is the notion that corporations need to be governed and that governance is actualised through the intervention of company directors.

2.4 THE CORPORATE BOARD AND COMPANY DIRECTORS

A review of the literature in previous sections highlights that companies are formed for the actualisation of identified purposes and this requires the involvement of persons in the management of companies. The selection and retention of company directors who are capable of ensuring the achievement of corporate objectives is a fundamental and core element of the corporate governance process.⁸⁷ Based on the concept of incorporation, a company is a separate legal entity, but must necessarily “act” through its human agents.⁸⁸

⁸⁶ See Du Plessis, (note 50) 43-44.

⁸⁷ See Tirole, (note 74).

⁸⁸ See s 16 of the United Kingdom Companies Act 2006. The United States has no uniform Companies Act, but see for instance The State of Delaware Code, Title 8 on Corporations, s 106 of which highlights the effects of incorporation and s 107 which states that incorporators shall “manage” the affairs of the company, credence to the fact that companies though legal entities cannot realistically manage themselves. See also H. Hansmann

Corporate law recognises the notion that a company can never develop hands and legs, neither can it acquire brains; and so its actions are basically those of its appointed agents.⁸⁹ As highlighted by Jensen & Meckling, the shareholders are the principals in the agency relationship whilst the managers are the company agents.⁹⁰ Corporate governance mechanisms have traditionally focused on the relationship between company directors and shareholders, and emphasised the role of the board.⁹¹ The UK Corporate Governance Code 2010 states clearly in its preamble that the board of directors are responsible for the governance of their companies. The term “director” had originally been used to describe the members of a governing board or the people in charge of the business of the joint stock company.⁹² The popularity of the company as a business form and the issue of separated ownership from control arising out of the fact that investors of capital are not usually professional managers necessitated the appointment of “directors” to oversee the affairs of the modern day company.⁹³

Despite the evidence in corporate law and corporate governance that directors are traditionally the persons charged with the management of companies, they were at some point regarded as “ornaments on a corporate Christmas tree”,⁹⁴ and the chief executive officer (CEO) and management team were relied upon to undertake the responsibility of organisational performance.⁹⁵ Mace argued that directors were incapable of exerting effective impact on the companies they governed because their existence was viewed as more of a legal requirement than as originating from a practical need because the management

& R. Kraakman, ‘What is Corporate Law?’ (2004) *Centre for Law, Economics and Public Policy Research Paper No. 300*.

⁸⁹ See for instance s 155 of the United Kingdom Companies Act 2006 which highlights the necessity of human agents by specifying that at least one director of any company must be a natural person.

⁹⁰ See Jensen & Meckling, (note 29) 308.

⁹¹ Corporate governance codes emphasize the role of the board as one of strategic leadership. See A.1 Supporting Principle in the UK Corporate Governance Code 2010.

⁹² See R.R. Formoy, *The Historical Foundations of Modern Company Law* (London: Sweet & Maxwell 1923); see also C. O’Donnell, ‘Origins of the Corporate Executive’ (1952) 26 *Bulletin of the Business Historical Society*; see also F.A. Gevurtz, ‘The European Origins and the Spread of the Corporate Board of Directors’ (2004), 33 *Stetson Law Review* 925.

⁹³ See Berle & Means, (note 32). The emergence of the principle of limited liability in UK company law in 1855 and the Companies Act 1862 contributed towards companies becoming the preferred vehicle for business activities. Also, the decision in cases like *Salomon v Salomon & Co Ltd* [1897] AC 22 which promoted the separate legal personality principle encouraged the adoption of the company as a business organisation.

⁹⁴ These descriptions gave credence to the perceived passivity associated with the role of director. See L.A.A Van den Berghe & A. Levrau, ‘Evaluating Boards of Directors: What Constitutes a Good Corporate Board’ (2004) 12(4) *Corporate Governance: An International Review* 461-478 at 461 referring to J.A. Bryne, ‘Boardroom Changes that Could Rebuild Trust’ (Commentary in *Business Week*, 17th June 2002).

⁹⁵ See C.G. Kiel & G.J. Nicholson, ‘Evaluating Boards and Directors’ (2005) 13(5) *Corporate Governance: An International Review* 613-631.

team appeared more in control of organisational affairs.⁹⁶ Today however, company directors are held increasingly accountable for corporate performance, a development which is underpinned by theoretical advances in agency theory and tales of corporate excesses, resulting in shareholders and stakeholders demanding that boards demonstrate leadership and control capabilities.⁹⁷ Monks & Minow highlight that vital company processes such as hiring, firing and compensation of management executives are now actively undertaken by the board of directors, an indication of their in-depth involvement in organisational development.⁹⁸ In essence, the function of the board of directors is now an aggregation of various aspects such as the development of strategy, assessment of executive performance and calibre, assessment of controls and audit systems, prevention and management of crises, facilitation of the flow of legal and ethical values as well as information dissemination.⁹⁹

Kiel & Nicholson argue that the role of the board of directors has metamorphosed from that of supporting the management team to actually partaking in company management, which is arguably their rightful place.¹⁰⁰ As a matter of law, directors are indeed the recognised corporate managers. UK company law, for instance, provides for the adoption of a Model Articles of Association by companies, and the Model Articles states that “subject to the articles, the directors are responsible for the management of the company’s business....”¹⁰¹ Article 5 of the Model Articles also grants the power of delegation to directors, so in effect, they may delegate their duties and powers to the management executives. However, the responsibility of company management remains with company directors. Directors are, therefore, the primary corporate managers and assume an agency relationship with the company as do the management executive in the same sense as was propounded by Jensen & Meckling. Lan & Heracleous argue that the company directors are not agents of the shareholders, but rather agents of the firm.¹⁰² That may appear so from their perspective, but nevertheless, there is an acknowledgement of an agency relationship in existence and an argument as to who the rightful principal should be does not preclude the existence of the relationship. The pertinent question here would be whether the company and the

⁹⁶ See M.L. Mace, *Directors: Myths and Realities* (Boston, MA: Harvard University Press 1971)

⁹⁷ See Kiel & Nicholson, (note 95).

⁹⁸ See R.A.G. Monks & N. Minow, *Corporate Governance* (Malden, MA: Blackwell Publishers 2004).

⁹⁹ See J.A. Confer, D. Finegold & E.E. Lawler, ‘Appraising Boardroom Performance’ (1998) 76 *Harvard Business Review* 136-148.

¹⁰⁰ See Kiel & Nicholson, (note 95).

¹⁰¹ See s 20, UK Companies Act 2006; see also Art 3 of the Model Articles for private limited companies and public companies.

¹⁰² See Lan & Heracleous, (note 38).

shareholders are one and the same? The legal doctrine of separate legal personality posits that the answer would be negative. However, one important issue is the fact that a company is usually formed by the shareholders,¹⁰³ and they are the directing will of the firm as encapsulated in the articles of association and in the appointment of directors. It is also recognised by law in the concept of lifting the veil of incorporation that a company is indeed a legal fiction.¹⁰⁴ Therefore, the company and its shareholders can be viewed as one and the same in certain cases.

Blair & Stout have argued that directors are not in any legal sense anyone's agent and that directors do not owe any duty of obedience to shareholders or to anyone else.¹⁰⁵ Arguing from the perspective of corporate law which specifies that directors must exercise independent judgment,¹⁰⁶ and case law which support this view,¹⁰⁷ the director primacy theorists argue that the directors are autonomous fiduciaries and not agents.¹⁰⁸ To the extent that directors do not owe a duty of obedience to shareholders and are mandated to exercise independent judgement, the director primacy theory makes some sense. However, considering the fact that directors are usually appointed by shareholders and can be removed by them as well, and are given authority to act on behalf of shareholders, especially in the case of dispersed share ownership, it does not seem realistic to abandon the agency theory.¹⁰⁹ The director primacy theorists also highlight the importance of trust in the fiduciary role of a director and argue that it is easier to obtain loyal behaviour from directors under the terms of

¹⁰³ See s 7 of the UK Companies Act 2006 which provides that subscribers may form a company.

¹⁰⁴ See the cases of *Gilford Motor Co Ltd v Horne* [1933] Ch 935; *Jones v Lipman* [1962] 1 WLR 832; *Adams v Cape Industries Plc* [1990] Ch 433; see also s 409 of the UK Companies Act for instance which requires parent companies to disclose details of its shareholding in subsidiaries; see also s 213-215 of the UK Insolvency Act 1986.

¹⁰⁵ See M. Blair & L. Stout, 'Corporate Accountability: Director Accountability and the Mediating Role of the Corporate Board' (2001) 79 *Washington Law Review* 403-447.

¹⁰⁶ See for instance s 173 of the UK Companies Act 2006; see also the US Business Judgement Rule, see S.M. Bainbridge, 'The Business Judgement Rule as Abstention Doctrine' (2004) 57 *Vand. Law Review* 83-128.

¹⁰⁷ See for instance *Regal (Hastings) Ltd v Gulliver* [1942] UKHL 1; see also *Hoyt v Thompson's Executors* [1859] 19 N.Y. 207; see also *Ripley v Storer* [1955] 142 N.Y.S. 2nd 269.

¹⁰⁸ See S. Bainbridge, 'Director Primacy: The Means and Ends of corporate Governance' (2003) 97 *North Western University Law Review* 547; see also S. Bainbridge, 'Director v Shareholder Primacy in the Convergence Debate' (2002) 16 *Transnational Lawyer* 45-62; see also L. Stout, 'Bad and not-so-bad Arguments for shareholder Primacy' (2002) 75 *Southern California Law Review* 1189-1209; see also Blair & Stout, (note 105).

¹⁰⁹ According to the law, the shareholders appoint the first directors and company secretary as specified under s 12 (1) of the UK Companies Act 2006. The directors may make subsequent appointments based on the powers delegated to them by the shareholders. It is pertinent to note however that in private companies for instance, directors are usually the principal shareholders and so the agent/principal relationship becomes less meaningful, see B. Clark & A. Benstock, 'UK Company Law Reform and Directors' Exploitation of "Corporate Opportunities"' (2006) 17(8) *International Company and Commercial Law Review* 231-241 at 235.

fiduciary duty law than it is by threatening liability under the terms of a contract.¹¹⁰ But, the agent also owes his principal certain duties which are in fact fiduciary in nature.¹¹¹ Fiduciary duties emanate from general common law principles which have been developed by the courts over time.¹¹² Therefore, the existence of an agency contract does not preclude the presence of a fiduciary relationship.¹¹³ Blair & Stout also argue that the directors should be viewed as “mediating hierarchs” who balance the conflicting claims of the various constituents in a firm.¹¹⁴ Certainly, there are various constituents of the firm who contribute to production, however, the company shareholders primarily appoint directors to run their company on their behalf. The powers of the directors cannot be exercised ultimately against the wishes of the shareholders because the owners of the company reserve the right to specify what is contained in the articles of association and direct the actions of directors.¹¹⁵ In any case, the success of a company depends on the effectiveness of its directors in governing the company. Tirole argues that selecting the appropriate company managers and rendering them accountable to investors is the bane of corporate governance.¹¹⁶ Irrespective of the theoretical arguments regarding the precise status of company directors, or the theory which best explains the firm, the practical outcome is that the board of directors are saddled with the management of companies, even though the directors may not be involved in the day to day running of the company in certain cases. Consequently, company directors are company

¹¹⁰ See Lan & Heracleous, (note 38) 303.

¹¹¹ See for instance The Partnership Act 1890, s 5 which describes the partners as agents and s 28-30 which specify duties which are fiduciary in nature. See also *Chaudhry v Prabhakar* [1989] 1 WLR 29; *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145; *Armstrong v Jackson* [1917] 2 KB 822; *Bristol and West Building Society v Mothew* [1998] Ch 1; *Kelly v Cooper* [1993] AC 205; *Hilton v Barker Booth and Eastwood* [2005] UKHL 8.

¹¹² Agents at common law owed the principal duties such as to act in the best interest of the principal, to avoid conflict of interest and to apply care and skill. These same duties are now codified under s 171-177 of the UK Companies Act 2006. In relation to the import of the agency relationship in companies at common law, see *Mahony v East Holyford Mining Co* [1875] LR 7 HL 869; *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480, per Diplock LJ at p 505; *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549.

¹¹³ This was implied by Lord Browne-Wilkinson in *Henderson v Merrett Syndicates Ltd*, (note 106) 205; see also *Bristol and West Building Society v Mothew*, (note 106), where Millett LJ noted that even though a solicitor had a fiduciary relationship with his client, every breach of the duty of care did not amount to a breach of a fiduciary duty. This is an indication that the duty of care which arises in an agency relationship can co-exist with fiduciary duties.

¹¹⁴ See Blair & Stout, (note 105).

¹¹⁵ See Art 4 of the Model Articles under UK Companies Act which refers to shareholders’ reserve power and provides that the shareholders may by special resolution direct the directors to take or refrain from taking specified action. See also *Hogg v Cramphorn Ltd* [1967] Ch. 254 where it was held that the improper issuance of shares could only be made valid if ratified by the shareholders. See also *Bamford v Bamford* [1970] Ch. 202.

¹¹⁶ See Tirole, (note 74).

agents carrying out governance functions on behalf of the company, the company being essentially its members, the shareholders.¹¹⁷

2.5 CORPORATE FAILURES

As discussed in section 2.3, corporate governance is concerned with the management of companies in order to achieve corporate goals. The last two decades have witnessed extensive debate on ways of improving corporate governance mechanisms from quarters such as governments, academics, lawyers, accountants, economists, business associations etc.¹¹⁸ One reason for this debate is the recurrence of corporate scandals and failures in most regions of the world. Examples include the corporate collapses of the Bank of Credit and Commerce (BCCI), Maxwell Group, Polly Peck and Barings Bank in the United Kingdom; WorldCom and Enron in the United States; HIH in Australia; and the corporate scandals involving Eurotunnel and the Shell Group.¹¹⁹ More recent examples include the collapses and near collapses of various banks and financial institutions in Europe and the United States.¹²⁰ Du Plessis points out that a history of business organisations shows that governance problems have existed from as early as the eighteenth century.¹²¹ However, as Cadbury highlighted,

¹¹⁷ See s 7 (1) of the UK Companies Act 2006 which provides that a company is formed by one or more persons subscribing their names to a memorandum and complying with the requirements of the Act as to registration of companies. See also s 8 (1) (b) of the Act which states that members of a company are shareholders in a company that has a share capital. Then s 112 of the Act also provides that the subscribers of a company's memorandum of association are the members of the company, along with any other persons who agree to become members and registered as such.

¹¹⁸ See A. Young, 'Frameworks in Regulating Company Directors: Rethinking the Philosophical Foundations to Enhance Accountability' (2009) 30(12) *Company Lawyer* 355-361.

¹¹⁹ See Salacuse, (note 16) 69-83; see also Wearing, (note 2); see also J.G. Hill, 'Regulatory Responses to Global Corporate Scandals' (2005) 23 *Wisconsin International Law Journal* 367.

¹²⁰ See the OECD Observer No 273, (note 9); see also A.S. Blinder, 'Crazy Compensation and The Crisis' (28 May 2009), *The Wall Street Journal*, p A 15; see also L. Bebchuk, A. Cohen & H. Spamann, 'The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008' (2009), *Harvard Law School Discussion Paper Series*.

¹²¹ See Du Plessis, (note 50) 44-51, where it is explained that a history of the United Kingdom business forms for instance would reveal the governance problems associated with the Bubble Act of 1720 which was indirectly responsible for the subsequent financial crash in England at the time. The company central to the crash was the South Sea Company, whose directors were eventually accused of various inappropriate conducts and behaviour. The Act basically condemned the trading of company stocks by businesses whose charter did not enable such transactions, rendering all such businesses illegal. However, some companies including the South Sea Company were excluded from the application of this Act. Before the promulgation of the Act, a scheme had been instituted by the government which drew considerable investment to the South Sea Company stock. After the Act came into force, there emerged a lot of uncertainty regarding the trade of stocks, and this situation started to affect stock prices. The South Sea Company directors subsequently manipulated their stock prices and created loans on the stocks as well. The ensuing panic following fluctuations in stock prices caused considerable losses and the South Sea Company directors were eventually tried and had their estates seized. Some of the effects of this governance problem in England was the subsequent reliance on partnerships as the preferred business vehicle until the nineteenth century and the

“corporate governance” as a term became prominent at least in the United Kingdom after the corporate collapses of the early 1990’s.¹²² Corporate governance reforms arising after corporate collapses would normally elicit a series of measures ranging from laws, listing rules and codes of best practices, all in the bid to forestall future occurrences of corporate mishaps.¹²³ Despite these measures, corporate scandals and failures have persisted.¹²⁴ Du Plessis argues that there are similarities between the corporate governance issues debated historically and those occurring in our society today.¹²⁵ This is true because an analysis of the events that contributed to the corporate failure in cases such as Maxwell, BCCI, HIH, Enron, WorldCom and Lehman Brothers would elicit similarities in the behaviour of the company directors. In the Maxwell failure, there were indications prior to the collapse of the company that he was not a person who could be relied on to govern a public company.¹²⁶ Lord Bingham in his investigation of the BCCI failure highlighted the falsification of company accounts perpetuated by the company directors.¹²⁷ The HIH Royal Commission Report indicates that the management of the insurance group had concealed the true state of the group’s financial position, a fact which contributed to its failure.¹²⁸ In the Enron failure, the executives were accused of manipulating company accounts amongst other issues.¹²⁹ Bernie Ebbers, the WorldCom CEO, was charged with fraud, conspiracy and making false statements in relation to the company accounts.¹³⁰ The Lehman Examiners Report states that there are colourable claims against the corporate officers who oversaw and certified

establishment of governmental agencies to scrutinize the conduct of company directors and managers, a situation which did not augur well with business men as they much preferred to govern themselves in the conduct of their businesses.

¹²² See A. Cadbury, ‘The Corporate Governance Agenda’ (2000), 8(1) *Corporate Governance: An International Review* 7-15 at 7 where he stated that “...the subsequent collapse of BCCI Bank, the Maxwell affair and the growing controversy over directors’ pay put governance issues on the public agenda for the first time...”.

¹²³ See for instance the Cadbury Report (1992) and Codes of Best Practice in the United Kingdom; and also the Sarbanes-Oxley Legislation in the United States.

¹²⁴ See Young, (note 118); see also T. Clarke, ‘Recurring Crises in Anglo-American Corporate Governance’ (2010) 29 *Contributions to Political Economy* 9-32.

¹²⁵ See Du Plessis, (note 50), regarding the behaviour of the company directors in the South Sea bubble; see <http://www.thesouthseabubble.com/> (accessed 15th June 2012) for a modernised commentary on the issue.

¹²⁶ See T. Bower, *Maxwell: The Outsider* (London: BCA 1992) 286-287.

¹²⁷ See Bingham, The Right Honourable Lord Justice, *Inquiry into the Supervision of the Bank of Credit and Commerce International*, London: HMSO, 1992.

¹²⁸ See the HIH Royal Commission Report 2003 available at www.hihroyalcom.gov.au/finalreport/index.htm (accessed 15th June 2012).

¹²⁹ See B. McLean & P. Elkind, *The Smartest Guys In The Room: The Amazing Rise And Scandalous Fall of Enron* (Penguin Group 2003); see also M. Swartz & S. Watkins, *Power Failure: The Inside Story of The Collapse of Enron* (New York: Doubleday 2003); see also S. Deakin & S.J. Konzelmann, ‘Learning from Enron’ (2004) 12(2) *Corporate Governance: An International Review* 134-142; see also J.C. Coffee, ‘What Caused Enron?, A Capsule Social and Economic History of the 1990s’ (2004) 89 *Cornell Law Review* 269.

¹³⁰ See L.W. Jeter, *Disconnected: Deceit and Betrayal at WorldCom* (New Jersey: Wiley & Sons 2003); see also *The Financial Times*, 4th March 2004, p 28.

misleading financial statements which in turn contributed to the corporate failure.¹³¹ The above examples illustrate that one of the issues which recur in corporate collapses is the inappropriate behaviour of company directors.¹³² The OECD highlighted four areas for urgent action in response to the on-going financial crisis and these are corporate risk management, pay and bonuses, performance of board directors and shareholder participation.¹³³ The behaviour of the board of directors was therefore a source of concern in the financial crisis. Therefore, if reduction and prevention of corporate failure is desired, it becomes important in corporate governance to investigate the linkage between the behaviour of company directors and corporate failures. It is equally important to understand the influence of personality and behaviour on corporate governance processes.

2.6 PERSONALITY AND BEHAVIOUR

It has been highlighted that corporate governance is a process which is undertaken primarily by company directors. These are persons engaging with the management processes in companies through their decisions and actions. Psychological research and literature has established that certain kinds of personalities produce certain kinds of behaviour, which is reflected in their decisions and actions.¹³⁴ This means that the personality of company directors is a significant factor in relation to their behaviour in the management of companies. In relation to behavioural issues in corporate governance, in the UK and US, there has been more focus on corporate governance structures in recent decades and far less focus on the behaviour of corporate officers who bring these structures to life.¹³⁵ Bragues argues that no

¹³¹ See The Lehman Examiners' Report, March 2010, Volume 1, p 17 & 20 <http://lehmanreport.jenner.com/VOLUME%201.pdf> (accessed 15th June 2012).

¹³² See R. Tomasic, 'Corporate Governance Failure: The Role of Internal and External Gatekeepers in UK Banks and Financial Institutions' (2010) 10(1) *Corporate Governance: International Journal for Enhanced Board Performance* 8-11; see also J.C. Coffee, 'What Went Wrong? An Initial Inquiry Into the Causes of the 2008 Financial Crisis' (2009) 9(1) *Journal of Corporate Law Studies* 1-22; see also W. Black, 'Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner' *A Statement Issued before the US House of Representatives Committee on Financial Services* (20th April, 2010); see also Wearing, (note 2); see also Young, (note 118); see also D. Nordberg, *Corporate Governance: Principles and Issues* (London: Sage Publications 2011) 2-3; see also R. Baker, 'Observations on the Current Crisis from a Corporate Governance Perspective' *Institute of Directors Report* (20th February, 2009); see also Kirkpatrick, (note 9).

¹³³ See the OECD Observer No 273, (note 9).

¹³⁴ See R.R. McCrae & P.T. Costa, 'Validation of the Five-Factor Model of Personality Across Instruments and Observers' (1987) 52(1) *Journal of Personality and Social Psychology* 81-90; see also M.R. Barrick & M.K. Mount, 'The Big Five Personality Dimensions and Job Performance: A Meta-Analysis' (1991) 44(1) *Personnel Psychology* 1-26; see also L.K. Trevino, 'Ethical Decision Making in Organisations: A Person-Situation Interactionist Model' (1986) 11 *Academy of Management Review* 607-617; see generally the discussions on personality in chapter five.

¹³⁵ For instance, the Cadbury Report on the Financial Aspects of Corporate Governance 1992 dealt with issues such as board structure and composition, board meetings, setting up committees for audit, remuneration,

matter how good the laws may be, they still have to be enforced by people and if these individuals are not of sound character, the laws will either be disregarded or twisted to suspect ends.¹³⁶ The UK Corporate Governance Code states clearly in its preface that the code is only a guide in general terms as to principles, structures and processes, and cannot guarantee board behaviour.¹³⁷ The question arises therefore as to what contributes to actual board behaviour. A number of studies have highlighted the need to investigate the behavioural processes of company boards in a bid to understand the conditions which aid effective corporate governance.¹³⁸ These studies focus on the company board as a whole. Ees, Gabrielsson & Huse highlight that most studies that have explored boards from an economic perspective have neglected actual board behaviour and have focused on the relationship between ideal board structures and corporate performance.¹³⁹ Behavioural theories of the firm as illustrated in the works of March & Simon, Cyert & March and Argote & Greve are founded on the concepts of bounded rationality, satisficing, routine decision making and political bargaining in the context of coalitions; and there are also theories regarding organisational culture and its impact on behaviour within an organisation.¹⁴⁰ These

nominations, etc. The UK Corporate Governance Code 2010 still focuses on the same issues. In the US, the Sarbanes-Oxley Act in s 406 mandates a disclosure as to whether a company had complied with a code of ethics, but does not necessarily mandate a compliance with such a code. However, the NYSE Corporate Governance Guidelines in s 303A.10 of its Listing Manual mandates the adoption of a code of ethics, even though most of the provisions of the guidelines deal with structural issues as well. See Van den Bergh & Levrau, (note 94).

¹³⁶ See G. Bragues, 'The Ancients against the Moderns: Focusing on the Character of Corporate Leaders' (2008) 78 *Journal of Business Ethics* 373-387 at 375.

¹³⁷ See the UK Corporate Governance Code 2010.

¹³⁸ See E.J. Zajac & J.D. Westphal, 'Toward a Behavioural Theory of the CEO/Board Relationship: How Research Can Enhance Our Understanding of Corporate Governance Practices' in D.C. Hambrick, D.A. Nadler & M.L. Tushman (eds.), *Navigating Change: How CEOs, Top Management Teams and Boards of Directors Steer Transformation* (Cambridge MA: Harvard Business School Press 1998); see also D.P. Forbes & F.J. Milliken, 'Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups' (1999) 24 *Academy of Management Review* 489-505; see also T. McNulty & A. Pettigrew, 'Strategists on the Board' (1999) 20 *Organisation Science* 40-74; see also M. Huse, 'Accountability and Creating Accountability: A Framework for Exploring Behavioural Perspectives of Corporate Governance' (2005) 16 *British Journal of Management* 65-80; see also R. Leblanc & M.S. Schwartz, 'The Black Box of Board Process: Gaining Access to a Difficult Subject' (2007) 15 *Corporate Governance: An International Review* 843-851.

¹³⁹ See H.V. Ees, J. Gabrielsson & M. Huse, 'Toward a Behavioural Theory of Boards and Corporate Governance' (2009) 17(3) *Corporate governance: An International Review* 307-319 at 315.

¹⁴⁰ See J.G. March & H.A. Simon, *Organisations* (New York: Wiley 1958); see also R.M. Cyert & J.G. March, *A Behavioural Theory of the Firm* (Englewoods Cliffs, NJ: Englewoods Prentice-Hall 1963); see also L. Argote & H.R. Greve, 'A Behavioural Theory of the Firm: 40 years and Counting, Introduction and Impact' (2007) 18 *Organisation Science* 337-349. In relation to issues of organisational culture, see D. Ravasi & M. Schultz, 'Responding to Organisational Identity Threats: Exploring the Role of Organisational Culture' (2006) 49(3) *Academy of Management Journal* 433-458 who describe organisational culture as a set of shared mental assumptions which guide interpretation and actions in organisations by defining appropriate behaviour for various situations; see also T.E. Deal & A.A. Kennedy, *Corporate Cultures: The Rites and Rituals of Corporate Life* (Harmondsworth: Penguin Books 1982) who define organisational culture simply as "the way things get

concepts lend perspectives towards understanding organisational behaviour and group decision making, but do not explain individual behaviour and decision making in its entirety. Board behaviour would be the aggregate sum of individual behaviour and the factors that influence organisational behaviour, such as situations and organisational culture. Situational elements and organisational culture are factors which are important in determining board and individual behaviour. It has been stated earlier in chapter one that behaviour consists of personality and situations. Therefore, the behaviour of directors in an organisational setting would be influenced by situations which exist within that organisation. Organisational culture can also impact on behavioural outcomes to the extent that the board can act in ways which conform to the tenets of the culture established within that organisation. However, some of the actions and decisions that have led to corporate failures were taken by individual directors. It is, therefore, important to investigate the drivers of individual behaviour because considering the negative impact of corporate failures on society,¹⁴¹ efforts made towards improving corporate governance mechanisms become important.

The UK Walker Review 2009 contains recommendations as to the requisite behaviour to be expected of board members. The findings state that board behaviour cannot be regulated or managed through organisational structures and controls alone. Also, there is a recommendation for independent assessments of board members at appointment and annually, and a statement which indicates that a full psychological assessment should include assessment of behaviour, experiences, knowledge, motivation and intellect.¹⁴² The Institute of Chartered Secretaries and Administrators (ICSA) also highlighted in their report on

done around here" and suggest four classifications of organisational culture-Tough-guy Macho culture, Bet your company culture, Work hard-Play hard culture and Process culture; see also C.B. Handy, *Understanding Organisations* (3rd ed., Harmondsworth: Penguin Books 1985) who proposed four types of culture, Power-based culture, Role-based culture, Task-based culture and Person-based culture; see also E.H. Schein, *Organisational Culture and Leadership* (San Francisco: Jossey-Bass 2004).

¹⁴¹ These include job losses, capital ruins, social implications, loss of confidence in capitalism etc. See Bower, (note 126); see also The FSA Press Release 'Financial Regulation: Learning the Lessons of Maxwell' (2001) at <http://www.fsa.gov.uk/Pages/Library/Communication/PR/2001/143.shtml> (accessed 15th June 2012); see also Wearing, (note 2); see also J. Unerman & B. O'Dwyer, 'Enron, WorldCom, Andersen et al: A Challenge To Modernity' (2004) 15 *Critical Perspectives on Accounting* 980; see also McLean & Elkind, (note 129); see also Deakin & Konzelmann, (note 129); see also B. Arnold & P. De Lange, 'Enron: An Examination of Agency Problems' (2004) 15 *Critical Perspectives on Accounting* 757; see also D. Greenwood, 'Enronitis: Why Good Corporation Go Bad' (2004) 3 *Columbia Business Law Review* 774; see also J. Andrew, K. Cooper & K. Islam, 'Dolorous Songs & Blessing of the Curses: Corporate Governance in Australia' (2006) 9(2) *The Journal of American Academy of Business* <http://ro.uow.edu.au/compapers/183/> (accessed 15th June 2012); see also The Lehman Examiners Report, (note 131).

¹⁴² See Annex 4 of the Walker Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations, 26th November 2009.

boardroom behaviour (prepared in June 2009 for the Walker review) that the degree to which best practice board room behaviours can be delivered is shaped by a number of key factors, the first of which is the character and personality of directors and the dynamics of their interactions.¹⁴³ ICSA also noted that weaknesses in the application of governance processes lie at the heart of some of corporate collapses and an analysis of recent governance failures required responses at three levels namely institutional, organisational and behavioural.¹⁴⁴

The UK Corporate Governance Code does not contain provisions which relate to the personality of company directors. Reverting to the formation of a company under corporate law, the directors are appointed by the shareholders. Shareholders normally delegate the powers of subsequent appointment of company directors to the existing directors. Under corporate governance requirements in the UK and US, the board of directors effects appointments to the board through the nominations committee.¹⁴⁵ These modes of appointments of directors do not specify that company directors must conform to any specific personality dimension. Based on the fact that different personalities produce different behaviours, and particularly for the reason that certain personality types are more conducive to corporate governance,¹⁴⁶ it is noteworthy that the selection and appointment of directors is not usually accompanied by personality and behavioural assessment under corporate law and corporate governance codes.¹⁴⁷ In the UK, the financial services sector is regulated by the Financial Services Authority (FSA) and there is an Approved Persons Regime in place which evaluates persons who are authorised to carry out certain functions in regulated firms.¹⁴⁸ As regards the influence of the regime on individual behaviour, two schools of thought emerge. One perception is that the regime makes no difference to behaviour and one is either the type of person who is professional or not.¹⁴⁹ The other perception is that the regime influences

¹⁴³ See the report at

<http://www.icsa.org.uk/assets/files/pdfs/consultations/2009/09.04%20ICSA%20Policy%20Report%206.pdf> p 4 (accessed 15th June 2012).

¹⁴⁴ Ibid, 7.

¹⁴⁵ See the UK Corporate Governance Code June 2010 Provision B.2.2; see also the NYSE Corporate Governance Guidelines which provides for the nomination committee in s 303 A.04 of the Listing Manual.

¹⁴⁶ See S.A. Kirkpatrick & E.A. Locke, 'Leadership: Do Traits Matter?' (1991) 5 *Academy of Management Executive* 48-60; see also R.P. Tett, D.N. Jackson & M. Rothstein, 'Personality Measures as Predictors of Job Performance: A Meta-Analytic Review' (1991) 44 *Personnel Psychology* 703-742.

¹⁴⁷ The UK Companies Act 2006 has no provision which specifies particular personal qualifications for directors. See s 157 which merely specifies a minimum age. The UK and US corporate governance codes also have no provisions dealing with personality assessment; see note 145.

¹⁴⁸ See the FSA Handbook; see also I. P. Dewing & P. O. Russell, 'The Individualisation of Corporate Governance: the Approved Persons' Regime for UK Financial Services Firms' (2008) 21(7) *Accounting, Auditing & Accountability Journal* 978-1000; the FSA regime is discussed in more detail in chapter three and seven.

¹⁴⁹ See Dewing & Russell, *ibid* 990.

behaviour and people are made to act more professionally because they have an additional responsibility beyond the company to the FSA.¹⁵⁰

Corporate governance codes and guidelines provide for an evaluation process but it is not one that focuses on the personal characteristics of company directors. The nominations committee is required to evaluate the balance of skill, knowledge and experiences required on the board and then take that into consideration in making recommendations for new appointments.¹⁵¹ The predominant form of “evaluation” recommended in corporate governance codes and guidelines is the performance evaluation to be undertaken during the continuance of the service.¹⁵² Hence, most of the literature on board and director evaluation addresses performance evaluation. It is essential to discuss the relevant literature in this regard as it highlights the issues which have been focused on in terms of evaluation processes in corporate governance. Kiel & Nicholson argue that performance evaluation is a key means by which boards can recognise and correct corporate governance problems and add value to their companies.¹⁵³ They identify four categories of governance failure: Strategic, Control, Ethical and Interpersonal Relationship failure. They draw up a framework for board evaluation which addresses issues such as what are the objectives of the evaluation, who will be evaluated, what will be evaluated, who will conduct the evaluation, what methods will be used, and how will the results be used. This framework covers the essential elements that are needed in the actualisation of a functional and effective evaluation framework. As regards who will be evaluated, Kiel & Nicholson further suggest that the board and then key governance personnel such as the CEO and company secretary should be evaluated. This is a positive step which goes further than what is recommended in the codes.

Long argues that it is equally the responsibility of shareholders and stakeholders to encourage an evaluation process which reflects integrity of purpose and which increases the levels of knowledge and understanding for those operating within the board.¹⁵⁴ Van den Berghe & Levrau identify that the three main criteria often used in academic research to evaluate board effectiveness are board size, board composition and board leadership structure.¹⁵⁵ They argue

¹⁵⁰ See Dewing & Russell, *ibid*.

¹⁵¹ See the UK Corporate Governance Code 2010, B.2.1 and B.2.2 provisions.

¹⁵² See the UK Corporate Governance Code 2010, B6 Main Principle; see also s 303A.09 of the NYSE Corporate Governance Guidelines in its Listing Manual.

¹⁵³ See Kiel & Nicholson, (note 95).

¹⁵⁴ See T. Long, ‘This Years’s Model: Influences on Board and Director Evaluation’ (2006) 14(6) *Corporate Governance: An International Review* 547-557.

¹⁵⁵ See Van den Berghe & Levrau, (note 94).

that the board has to have appropriate people as well as the structures for it to function effectively because structures are brought alive by people. They further argue that structures can only facilitate effectiveness and therefore, more emphasis should be placed on the selection and re-election of directors. Ingley & Van der Walt focus on performance appraisal and highlight that there are disagreements in governance literature about the usefulness of evaluations because of the type of evaluations in governance which appears horizontal, as against the widely accepted vertical evaluation which is obtainable in management literature.¹⁵⁶ They further argue that there should be consistency in the process of selecting directors and the board evaluation process.

Kazanjian argues that one advantage of board and director assessment is that it addresses the problems of shareholder accountability.¹⁵⁷ He points out different reasons why the evaluation process is not carried out with enthusiasm, such as that in the UK for instance, individual director evaluation is seen as unnecessary because the board is viewed as a whole, and the evaluation process seems too full of processes, highlighting that the alternative to self-evaluation recommended by codes is rules and laws which would still be full of processes and encroach on corporate decision making, and that directors feel uncomfortable by the fact that they are being assessed and judged. Kazanjian also argues that boards shy away from evaluation because it may uncover governance problems, disrupt open interaction and the collegiality within the board and the evaluation results may also be unreliable considering the process may not have been carried out effectively, efficiently and objectively.¹⁵⁸

As stated earlier, most of the literature which relates to evaluation in corporate governance does not deal specifically with personality evaluation at the point of selecting directors; however, there are authors who have highlighted more elaborately the need for an adequate evaluation process at the recruitment stage. Lee & Phan argue that the selection and evaluation of directors should be made in terms of competencies that are both generic to board activities and specific to global firms.¹⁵⁹ They identify some personal qualities of an effective director as being generic, and these include strength of character, integrity, sound judgement, business sense. They also refer to the work of Dulewicz & Herbert who

¹⁵⁶ See C. Ingley & N. Van der Walt, 'Board Dynamics and the Politics of Appraisal' (2002) 10(3) *Corporate Governance: An International Review* 163-174.

¹⁵⁷ See J. Kazanjian, 'Assessing Boards and Individual Directors' (2000) 64(5) *Ivey Business Journal* 45-50.

¹⁵⁸ Ibid.

¹⁵⁹ See S. Lee & P. Phan, 'Competencies of Directors in Global firms-Requirements for Recruitment and Evaluation' (2000) 8(3) *Corporate Governance: An International Review* 204-214.

postulated the twelve competences of directors as strategic perspective, business sense, planning and organising, analysis and judgement, managing staff, persuasiveness, assertiveness and decisiveness, interpersonal sensitivity, communication, resilience and adaptability, energy and initiative, achievement and motivation.¹⁶⁰ Minichilli, Gabrielsson & Huse state that seeing the advantages of an effective board evaluation process, it is surprising to note that board evaluations have not received more attention in theory and in practice.¹⁶¹ They acknowledge that board evaluations can contribute to effective boards and improve corporate performance. They further argue for improved systems of evaluation taking cognisance of issues such as who does the evaluation, what is evaluated, for whom it is done and how it is done, bearing in mind the importance of fitting the system used to the purpose of the evaluation. They present four evaluation systems based on the end users of the evaluation outcome.¹⁶²

Under examples of what can be evaluated, Minichilli, Gabrielsson & Huse refer to board membership which includes evaluation of issues such as director's education, professional background, and capabilities. As regards who conducts the evaluation, they suggest consultants, researchers, and other external agents as possible evaluators. It is noteworthy that they argue that evaluation should include an assessment of the capabilities of directors. Considering the fact that personality is a significant factor as it relates to behaviour, it is essential to also evaluate company directors based on their personal characteristics, particularly at the point of recruitment. It is equally important to investigate the relationship between personality and behaviour in order to provide more knowledge regarding the issues and enable an informed approach in relation to developing evaluation mechanisms which take cognisance of those issues. As stated in chapter one, the behaviour of directors was highlighted as a point of concern in recent corporate failures; and reflecting on the inappropriate behaviour of corporate officers in corporate collapses of the early 1990s and 2000s, it becomes essential to adopt a risk view of behavioural issues in corporate governance as it is apparent that behavioural risks contribute to corporate failure.

¹⁶⁰ See V. Dulewicz & P. Herbert, 'Predicting Advancement to Senior Management from Competencies and Personality Data: A Seven Year follow-up Study' (1999) 10 *British Journal of Management* 13-22.

¹⁶¹ See A. Minichilli, J. Gabrielsson & M. Huse, 'Board Evaluations: Making a fit between the Purpose and the System' (2007) 15(4) *Corporate Governance: An International Review* 609-622.

¹⁶² Ibid.

2.7 CORPORATE RISK AND RISK MANAGEMENT

Considering the argument that personality and behavioural issues contribute to corporate failures and, therefore, constitute risks in the corporate governance process, it is essential to understand the meaning of risk. It is also necessary to understand what risk management entails as that is pivotal in the determination of solutions which address perceived risks in corporate governance. Historically, risk has been defined as measurable uncertainty.¹⁶³ It is the potential for unwanted negative consequences of an event or activity.¹⁶⁴ Agrawal argues that risk represents the numerous types of threats caused by environment, technology, humans, organisations, politics etc.¹⁶⁵ Therefore, humans as well as organisations are risk originators, as risk is conceived in human and organisational activities. Risk can be framed and classified in various ways, one of which is its origin.¹⁶⁶ Corporate risks are, therefore, risks that emanate from the corporation in its functioning processes.¹⁶⁷ Risk management is the act of taking action to mitigate the occasion or implication of risk.¹⁶⁸ In corporate governance, the understanding of risk and its implications for the company is evidenced in the Turnbull Guidance which states that “A company’s system of internal control has a key role in the management of risks that are significant to the fulfilment of its business objectives”.¹⁶⁹ The Revised Turnbull Guidance states that “A company’s objectives, its internal organisation and the environment in which it operates are continually evolving and, as a result, the risks it faces are continually changing. A sound system of internal control therefore depends on a thorough and regular evaluation of the nature and extent of the risks to which the company is exposed. Since profits are, in part, the reward for successful risk-taking in business, the purpose of internal control is to help manage and control risk appropriately rather than to eliminate it”.¹⁷⁰ The board of directors is primarily responsible

¹⁶³ See F.H. Knight, *Risk, Uncertainty, and Profit* (Boston, MA: Hart, Schaffner & Marx; Houghton Mifflin Co 1921); chapter three discusses risk in more detail.

¹⁶⁴ See W.D. Rowe, *An Anatomy of Risk* (New York: John Wiley & Sons 1977).

¹⁶⁵ See R.C. Agrawal, *Risk Management* (Jaipur, India: Global Media 2009) 35.

¹⁶⁶ See S.A. Drew & T. Kendrick, ‘Risk Management: The Five Pillars of Corporate Governance’ (2005) 31(2) *Journal of General Management* 19-36 at 21.

¹⁶⁷ See T. Merna & F. Al-Thani, *Corporate Risk Management* (2nd ed., Chichester: John Wiley & Sons 2008).

¹⁶⁸ See P. O’Reilly, *Harnessing the Unicorn: How to Create Opportunity and Manage Risk* (London: Gower Publishing Ltd 1998); see also A. E. Waring & A.I. Glendon, *Managing Risk* (London: International Thompson Business Press 1998).

¹⁶⁹ The Turnbull Guidance was promulgated by the Turnbull Committee which was set up to investigate internal control and risk management practices in companies, and it sets out best practice in this regard for companies as well as providing guidance on the application of section C.2 of the UK Corporate Governance Code. See The Turnbull Guidance-*Internal Control: Guidance for Directors on the Combined Code-1999*, 4.

¹⁷⁰ See The Revised Turnbull Guidance-*Internal Control: Revised Guidance for Directors on the Combined Code-October 2005*, 3.

for risk taking and risk management in a company and bear the task of maintaining the internal controls in the company.¹⁷¹

The UK Corporate Governance Code also states that the board should maintain sound risk management and internal control systems.¹⁷² Enterprise Risk Management (ERM) has also developed as a framework which elevates risk discussions and management to strategic levels in companies.¹⁷³ ERM is basically the identification and assessment of the collective risks that affect firm value and the implementation of a firm-wide strategy to manage those risks.¹⁷⁴ The Committee of Sponsoring Organisations of the Treadway Commission (COSO) issued an integrated framework to provide a model for ERM. That framework defines ERM as “a process effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives”.¹⁷⁵ The COSO Framework also defines risk as “the possibility that an event will occur and adversely affect the achievement of [entity] objectives”.¹⁷⁶ From the foregoing, it can be gleaned that risk represents factors which may prevent a company from achieving its objectives. Part of ensuring that companies achieve their objectives is preventing corporate failures.¹⁷⁷ It therefore means that the risks which contribute to corporate failures should be managed effectively. The examples of corporate failures that have been highlighted and the contributory element of behavioural issues to those failures is an indication that the behaviour of company directors is a risk issue in respect of corporate governance processes. The fact that personality contributes to behavioural issues places personality as a risk element as well in relation to behaviour. The crux of the matter then remains whether present corporate governance mechanisms are effective in relation to managing personality risks and in turn behavioural risks, or whether other options such as regulation in that regard would prove more effective.

¹⁷¹ See The Revised Guidance, *ibid* 6.

¹⁷² See The UK Corporate Governance Code 2010, (Principle C.2).

¹⁷³ See The Conference Board, *Emerging Governance Practices in Enterprise Risk Management*, 2005.

¹⁷⁴ See L. Meulbroek, ‘The Promise and Challenge of Integrated Risk Management’ (2002) 5(1) *Risk Management and Insurance Review* 55-66.

¹⁷⁵ See The Committee of Sponsoring Organisations of the Treadway Commission (COSO), *Enterprise Risk Management-Integrated Framework*, September 2004.

¹⁷⁶ See The COSO Framework, *ibid* 4.

¹⁷⁷ See The UK Corporate Governance Code 2010, p 1 where it is stated that “The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company”, corporate failure would definitely cut short the success of a company.

2.8 REGULATORY THEORIES

The problems associated with personality and behavioural risks in respect of corporate governance processes require that mechanisms are developed to manage those risks if effectiveness is to be achieved. One of the possible options and the one suggested in this thesis is regulatory intervention. There are various theories regarding the import of regulation and how best to achieve effective regulatory outcomes. It is pertinent to examine the relevant regulatory theories in this regard in order to ascertain different perspectives and enable an evaluation of which regulatory approaches are justifiable and would best achieve the desired aim. Ayres & Braithwaite argue that based on economic analysis and empirical research, a highly punitive regulatory regime engenders a subculture of resistance and a crucial danger of a punitive posture that projects negative expectations of the regulated actor in that it inhibits self-regulation.¹⁷⁸ They argue further that a solely punitive regime leads to firms defying the spirit of the law by exploiting loopholes and then the State ends up creating more specific laws to cover the loopholes.¹⁷⁹ It has also been noted that a regulator that establishes a relationship with the regulated and exercises a degree of discretion is usually preferred and the regulated would feel more open if the regulator confers benefits as well as policing duties, for example the stock exchange in the UK.¹⁸⁰

In line with reducing transaction costs, Ayres & Braithwaite argue that States should produce regulation only when it is the cheapest option of regulation for the purpose, otherwise external contracting in the form of self-regulation by private actors should be employed.¹⁸¹ This external form of regulation, they say, is cheaper because it is internal to the regulated and achieves better cooperation and depth within the company; and it would also enable the avoidance of over-strict rules for smaller enterprises and the rules that evolve with fast changing circumstances.¹⁸² Ayres & Braithwaite also argue for a tripartite regulatory framework, with public interest groups (such as environmental agencies, employees, institutional shareholders etc.) being empowered to intervene in the relationship between the regulator and the regulated in order to prevent capture and corruption.¹⁸³ They also suggest a

¹⁷⁸ See I. Ayres & J. Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford: Oxford University Press 1992) 19-25.

¹⁷⁹ See Ayres & Braithwaite, *ibid* 26.

¹⁸⁰ The Stock Exchange undertakes policing duties under its listing rules, but also confers benefits by facilitating the trading of company shares. See Dine, (note 49) 130-131.

¹⁸¹ See Ayres & Braithwaite, (note 178) 103.

¹⁸² *Ibid*.

¹⁸³ See Ayres & Braithwaite, (note 178) 82-84.

pyramid of sanctions, from lower level sanctions to heavier penalties in cases of non-cooperation.¹⁸⁴ Therefore, due to issues such as resentment, inefficiency, expense and uncertainty of enforcing punitive laws, it is arguably better to create cooperative laws.¹⁸⁵

Baldwin & Cave¹⁸⁶ note that the issue of regulation requires a multidisciplinary approach, cutting across law, economics, political science, sociology, psychology, management etc. They refer to Selznick's idea of the central meaning of regulation as "sustained and focused control exercised by a public agency over activities that are valued by a community".¹⁸⁷ Regarding the reasons why a State may decide to regulate, Baldwin & Cave point to issues such as monopolies in the market, regularising windfall profits, externalities or spill overs, information inadequacies, continuity and availability of service, anti-competition or predatory pricing, public goods or moral hazards, unequal bargaining power, scarcity and rationing, distributional justice and social policy, rationalisation and coordination and planning for future generations.¹⁸⁸ As regards approaches to the origin and development of regulation, Baldwin & Cave identify public interest theories, interest group theories, private interest theories, force of ideas theory and institutional theories.¹⁸⁹ In the public interest theory approach, the purpose of regulation is to achieve certain publicly desired goals in circumstances where for instance the market would fail to yield those results. Proponents of regulation in this regard act as agents of public interest.

Baldwin & Cave point out problems with this theory, such as the absence of a clear definition of what constitutes public interest, failings on the part of regulators to actually pursue public ends, and the fact that public interest theorists under estimate the power of economic and political influence over regulation.¹⁹⁰ Therefore, in the final analysis, regulation purported to be in the public interest may actually be in the interest of particular groups who influenced it

¹⁸⁴ See Ayres & Braithwaite, (note 178) 35-36.

¹⁸⁵ See R. Baldwin, 'The New Punitive Regulation' (2004) 67(3) *Modern Law Review* 382-383 where it is stated that punitive, command or deterrence approaches to regulation and enforcement are severely limited in potential and proactive regulatory strategies which involves the cooperation of companies should be considered. It is also noted that proactive approaches, just like punitive approaches, have to take cognisance of the differences in points of view as regards regulation and compliance between the regulators and the regulated.

¹⁸⁶ See R. Baldwin & M. Cave, *Understanding Regulation: Theory, Strategy & Practice* (Oxford: Oxford University Press 1999) 1.

¹⁸⁷ See P. Selznick, 'Focusing Organisational Research on Regulation' in R. Noll (ed.), *Regulatory Policy and the Social Sciences* (Berkeley: University of California Press 1985) 363.

¹⁸⁸ See Baldwin & Cave, (note 186) 9-16.

¹⁸⁹ See Baldwin & Cave, (note 186) 19-32.

¹⁹⁰ See Baldwin & Cave, (note 186) 20.

and made it appear as if it was done in the interests of the public.¹⁹¹ In instances such as this, the interest group theory intertwines with the public interest theory. Interest group theorists view regulation as being a result of the relationship between different groups and between such groups and the state.¹⁹² In the private interest theory, regulation is driven by purely private interests, although there is sometimes an overlap between private and group interest approaches.¹⁹³ The force of ideas approach connotes a situation in which regulation is a result of intellectual conceptions which express how and why the government ought to intervene in a market.¹⁹⁴ This basically involves the government rationalising its reasons for regulation based on its ideas of what ought to be in place. Institutionalism theorists argue that institutional structures as well as social processes drive regulation and regulatory intervention goes beyond an aggregation of individual preferences.¹⁹⁵ These institutions include law, economic, political and religious units, with each exerting its own influence on the regulatory process.¹⁹⁶

Ogus points out that in all industrialised societies, there is a tension between two systems of economic organisation, the market system and the collectivist system.¹⁹⁷ The role of the law in the market system is simply to facilitate the functioning of the market by offering a set of formalised arrangements with which individuals can go about their welfare seeking activities and relationships. These arrangements are usually through instruments of private law. In the collectivist system, the State seeks to direct or encourage behaviour which would not otherwise occur without such intervention and the aim is to correct perceived deficiencies in the market as regards its ability to meet collective public goals.¹⁹⁸ Ogus makes a distinction between social and economic regulation and reiterates that the public interest theory of regulation rests on justifications such as that the consumers of goods and services often have inadequate information concerning the quality offered by suppliers and so the unregulated market may fail to meet their preferences.¹⁹⁹

¹⁹¹ For more arguments on the theory of public interest, see M. Hantke-Domas, 'The Public Interest Theory of Regulation: Non-Existence or Misinterpretation?' (2003) 15 *European Journal of Law and Economics* 165-194.

¹⁹² See Baldwin & Cave, (note 186) 21.

¹⁹³ See Baldwin & Cave, (note 186) 22.

¹⁹⁴ See Baldwin & Cave, (note 186) 26.

¹⁹⁵ See Baldwin & Cave, (note 186) 27.

¹⁹⁶ See Baldwin & Cave, (note 186) 31.

¹⁹⁷ See A. Ogus, *Regulation: Legal Form and Economic Theory* (Oxford: Clarendon Law Series 1994) 27.

¹⁹⁸ Ibid 2-3.

¹⁹⁹ Ibid 4-5.

Wright & Head²⁰⁰ explain different perspectives on regulation as follows:

- 1) Normative Theory: This theory makes prescriptive claims and connotes legally enforceable standards which are set and applied uniformly across the entire regulatory space. There are no tailored requirements to specific characteristics of individuals, firms or industries. The limitations of this approach are the needs of different sectors and expensive compliance regimes. Under this theory comes traditional directive regulation (command and control) which is often described as cumbersome, costly, inflexible, and inefficient.²⁰¹ There is also responsive regulation which engages the regulatory space, enforced by rational strategizing and self-regulatory techniques.²⁰² It suggests that governments should be attuned to appreciating the different motivations and characteristics of regulated entities and regulators must be able to respond differently and with measured levels of sanction to the diverse conducts of the industry. Both of these models aim to advance public purposes, but essentially, the traditional regulatory methods are better suited to a regulatory space with minimal diversity and where the regulated bodies have relatively uniform characteristics. Responsive regulation thrives in a place where regulators, the regulated and the community can build the basis for negotiated responsiveness.
- 2) Descriptive Theory-Smart Regulation: This theory emphasises the active role that specific contexts such as organisational, political, economic and cultural can play in deciding regulatory regimes and outcomes. It builds on responsive regulation but the major focus is in its contextualisation and it deals more with the specific issues confronted by an industry; for example environmental pollution or occupational health and safety rather than the normatively laden negotiation of responsiveness and rational strategizing. Central to this theory is the perspective that regulated bodies are always embedded in contexts that significantly influence their needs and compliance motivations. Smart regulation posits that regulatory studies must be undertaken at the lower level of generality and strategies should be formulated across specific social, economic and institutional contexts. It examines existing regulatory regimes in terms of strengths and weaknesses and indicates which new instruments might operate constructively. It also emphasises that optimal regulatory solutions require a mix of

²⁰⁰ See J.S.F. Wright & B. Head, 'Reconsidering Regulation and Governance Theory: A Learning Approach' (2009) 31(2) *Law & Policy* 192-216.

²⁰¹ Ibid.

²⁰² Ibid.

regulatory instruments. The strength of smart regulation lies in its sensitivity to the connection between governance arrangements and the cultural, economic and institutional contexts in which they are embedded. Smart regulation contributes to what is already in existence. One weakness of this mode of regulation is that it comes into play after substantive policy goals have been articulated and so it can only operate in a regulatory space where legitimacy is already assured. The descriptive perspective leads policy makers to ask important questions within a principle based framework, but in the absence of normative yardsticks there can be no guarantees.

- 3) Post Structuralism Theory-Nodal Governance: This theory highlights regulatory arrangements at the level of governance networks. Nodal governance posits that although power is transmitted across networks, the node is the point at which knowledge and capacity are organised and mobilised. Nodes can be companies, non-governmental organisations, community groups, government departments, associations etc. and can exist across specific sectors such as health, banking, education etc. The potential strength of the nodal model of regulation is the ability to map interactions and capacities of nodes, both as sites of continuity and of contestation. A disadvantage is the assumption of legitimacy outside the state.

As regards regulatory design, Gunningham & Grabosky²⁰³ suggest various principles which would aid the development of regulation in the environmental policy sector but which are also potentially useful in the analysis of regulatory designs in the commercial sector. The authors argue that adherence to these principles is at the heart of successful regulatory policy design and contribute towards effective and efficient regulation. These principles are as follows:

- 1) Adopting a mixture of regulatory instruments and applying only the minimum required to achieve the purpose.

Gunningham & Grabosky point out that individual regulatory instrument would in the majority of cases be inadequate to achieve a regulatory goal. For instance, command and control regulation would be dependable and predictable but would also be inflexible and inefficient. Economic regulation tends to be efficient but not dependable in most cases. Self-regulation has the advantage of being non coercive

²⁰³ See N. Gunningham & P. Grabosky, *Smart Regulation: Designing Environmental Policy* (Oxford: Oxford University Press 1998).

and cost effective, but it can be highly unreliable in a lot of cases and its success depends on the gap between public and private interests. Therefore, the best means of overcoming individual instrument deficiencies is to adopt a combination of instruments.

2) Less interventionist measures.

Gunningham & Grabosky argue that highly prescriptive and highly coercive instruments are not the most effective regulatory measures, and a more successful regime should aim to adopt the least interventionist measure in achieving the outcome.

3) Creating a regulatory pyramid.

Gunningham & Grabosky here distinguish between the regulatory pyramids proposed by Ayres & Braithwaite in which the state regulation is the single instrument and instead propose a mixture of instruments and regulatory participants.

4) Empower participants to act as surrogate regulators.

Gunningham & Grabosky argue that the state need not be the sole regulator and can create efficiency by engaging second and third parties who are in the best position to support the regulatory outcome.

5) Maximise opportunities for win-win outcomes.

Gunningham & Grabosky argue that there should be the opportunity for end users of the regulation to rise above mere compliance and benefit more widely from the regulatory intent. These principles are in keeping with the tenets of smart regulation which essentially connotes regulating in the most effective and efficient manner taking cognisance of the context in which regulation is desired.

In the consultation report on better regulation in the EU, it was noted that smart regulation is not about more or less regulation but is simply about delivering regulatory outcomes in the least burdensome way.²⁰⁴ It was also noted that regulation is a necessary aspect of modern society and in business it serves to create a level playing field for companies to operate in the

²⁰⁴ See The EU Better Regulation website, http://ec.europa.eu/governance/better_regulation/smart_regulation/docs/smart_regulation_consultation_en.pdf (accessed 15th June 2012).

market place. However, in designing regulatory instruments, governments are looking to employ the right regulatory tools which would maximise benefits and minimise negative effects, whilst being responsive to the needs of the end-users.²⁰⁵ It would then be reasonable to say that present realities demand that regulation must be needful, effective and efficient. Some general methods of regulation include the following:

1) External Prescriptive Rules.

Dine argues that this sort of regulation alone will not always be effective and satisfactory.²⁰⁶

2) Responsive Rules.

Ayres & Braithwaite argue in support of this model which thrives on the cooperation of the regulated.²⁰⁷

3) Internal Self-Regulation.

This involves private actors regulating in the place of the State.²⁰⁸

Dine argues that an ideal situation in terms of achieving regulatory outcomes is the regulator relating with the recipients of the regulation “in a relationship that ultimately has coercive power”.²⁰⁹ Examples would include corporate governance codes,²¹⁰ as well as the proceduralisation model²¹¹ rooted in the legal philosophy that regulation should be about the law taking a back stand as regards formulating substantive norms and instead focus on providing the framework and enabling environment for the decision making by ensuring that the best possible forum of interested parties can be convened to arrive at the eventual substantive norm.²¹² Dine further argues, however, that due to the influence and impact of

²⁰⁵ Ibid, http://ec.europa.eu/governance/better_regulation/documents/brochure/br_brochure_en.pdf (accessed 15th June 2012).

²⁰⁶ See Dine, (note 49) 146.

²⁰⁷ See Ayres & Braithwaite, (note 178).

²⁰⁸ See Ayres & Braithwaite, *ibid*.

²⁰⁹ See Dine, (note 49) 147.

²¹⁰ These are usually promulgated by the involvement of external participators other than the State, in the case of the UK Code the Cadbury Committee was set up by the Financial Reporting Council, the London Stock Exchange and the accountancy profession. See the Cadbury Committee Report, 1992.

²¹¹ This approach is highlighted by the arguments of Professor Jacques Lenoble, a Professor of Law at the Centre de Philosophie du Droit, Université Catholique de Louvain in Belgium, developing and incorporating elements of the arguments of Jurgen Habermas and Niklas Luhmann on pragmatism and the theory of social systems.

²¹² For developments of this philosophy and its impact on corporate governance, see J. Lenoble & M. Maesschalck, *Democracy, Law and Governance* (Aldershot, UK: Ashgate Publishing 2010); see also J. Lenoble &

corporate operations globally, there should be a rejection of “the underpinning of free market economics and the consequent demand of corporations to be permitted to self-regulate”.²¹³ She points out that the grave impact of the effect of corporate activities is a firm justification for stronger regulation.²¹⁴ Dine adds that there is clearly a place for codes and internal regulation, but the task is to institute a legal framework that can contribute towards enforcing internal self-regulation.²¹⁵ Ensuring that companies are effectively regulated should be the most important consideration, and the regulatory approach which achieves this aim is preferable in any case.

Comparing self-regulatory approaches to statutory intervention, Kirkbride & Letza discuss the UK Local Government Act 2000 which involves a National Standards Board with agreed codes of conduct and enforcement mechanisms, and observe that this public authorities’ regime is now more advanced than the corporate regime because its duties are more explicitly defined by statute.²¹⁶ They contend that since the public and private sector have an agenda in ensuring good corporate governance, the adoption of a similar regime in the corporate realm would be worthwhile. Ingley & Van der Walt also argue that there is a challenge for regulators and researchers to push for changes in the architecture of corporate governance in order to ensure that the full potential of the corporate board is realised.²¹⁷ Musikali argues that despite the reasons put forward in favour of self-regulation in corporate governance, government intervention is inevitable when markets have failed.²¹⁸ He argues that the stability of companies is important as the success of any economy in the 21st century lies in its ability to create and maintain successful corporations. Musikali further asserts that the survival and long-term profitability of corporations is now a matter of public interest, which

R. Cobbaut (eds.), *Corporate Governance: An Institutional Approach* (The Hague, Netherlands: Kluwer Law International 2003).

²¹³ See Dine, (note 49) 176.

²¹⁴ See Dine, (note 49) 177.

²¹⁵ See Dine, *ibid*; see also E. Ferran, ‘Corporate Law, Codes and Social Norms-Finding the Right Regulatory Combination and Institutional Structure’ (2001) 1 *Journal of Corporate Law Studies* 381-409 at 386.

²¹⁶ See J. Kirkbride & S. Letza, ‘Corporate Governance and Gatekeeper Liability: The Lessons from Public Authorities’ (2003) 11 *Corporate Governance: An International Review* 262-271. The operations of the National Standards Board was amended by the Local Government and Public Involvement in Health Act, 2007 to the extent that the bulk of investigations for breaches of the code of conduct was carried out by local standards committees and the national body investigated only the most serious cases. The UK coalition government has now abolished the Standards Board for England under the provisions of the Localism Act 2011, with the abolition taking effect from 1st April 2012. However, the Localism Act 2011 will still provide for local codes of conduct, and the standards regime for Wales is still in force.

²¹⁷ See C. Ingley & N. Van der Walt, ‘Do Board Processes Influence Director and Board Performance? Statutory and Performance Implications’ (2005) 13(5) *Corporate Governance: An International Review* 632-653.

²¹⁸ See L. Musikali, ‘Why Criminal Sanctions Still Matter in Corporate Governance’ (2009) 20(4) *International Company and Commercial Law Review* 133-141.

should to a certain degree be protected through State regulation.²¹⁹ He goes on to argue that private law mechanisms and non-law mechanisms have proved inefficient and ineffective in protecting shareholders and stakeholders from expropriation and excessive risk-taking, and so government intervention is not only desirable but necessary.²²⁰

From the emergence of the company as a business form, business leaders have been in favour of the view that businesses should be controlled by business persons and not by government officials, hence the current trend for the business community to promote soft law and self-regulation in corporate governance.²²¹ However, from the arguments highlighted above, corporate failures and the impact they have had on society are viewed as justification for government intervention.²²² Perhaps the important issue is to avoid over regulation and to identify the areas of corporate governance which would definitely function more effectively with statutory regulation.²²³ With regard to regulating the selection of corporate officers, Dulewicz & Herbert point out that only a minority of nominations committees focus on descriptors of high performance in evaluating appointees and traditional methods of director selection still prevail.²²⁴ If the aim is to improve corporate governance, then there is a reason for the selection process to take cognisance of all the elements which would affect a director's performance. Cadbury states that improvements in board accountability and performance are the aim of corporate governance reform.²²⁵ He argued that word of mouth or personal network approach to the selection of directors should be increasingly unacceptable, but acknowledges that old habits die hard and patronage breeds power and influence.²²⁶ He further argued that the pressure for a more formal selection process will come from institutional shareholders and the management team.²²⁷ He asserts that the link between assessment and selection is straightforward and the board should start a selection process to fill a vacancy by looking at the attributes of the present board members and thinking of issues

²¹⁹ Ibid.

²²⁰ Ibid.

²²¹ See Du Plessis, (note 50) 48 and the reference to DuBois, *The English Business Company after the Bubble Act*, (1938) and Carr, *Select Charters of Trading Companies AD 1530-1707* (1913).

²²² See Dine, (note 49) 176; see also Musikali, (note 218); Chapter Four discusses corporate failures and their impact on society.

²²³ This was also echoed in the EU consultation document on better regulation, (note 204).

²²⁴ See V. Dulewicz & P. Herbert, 'Current Practice of FTSE 350 Boards Concerning the Appointment, Evaluation and Development of Directors, Boards and Committees Post the Combined Code' (2008) 4(1) *International Journal of Business Governance and Ethics* 99-115.

²²⁵ See A. Cadbury, 'What are the Trends in Corporate Governance and How will they Impact your Company' (1999) 32(1) *Long Range Planning* 12-19.

²²⁶ See Cadbury, *ibid*

²²⁷ See Cadbury, *ibid*

such as age, gender, professional qualifications etc. and then decide where the gap is and seek to fill it.²²⁸

Cadbury notes that in the light of his experience on the Financial Aspects of Corporate Governance Committee in 1992, there are areas of governance which are not easily dealt with statutorily and he refers to the requirement for a certain “calibre” of non-executive directors, a qualitative judgement which shareholders are able to make but cannot be framed in legal language.²²⁹ This may be true, but on the other hand, allowing shareholders to make that judgement based on undefined or unclearly defined criteria can encourage discretion which could result in inconsistent judgements. This might result in situations where different standards are propagated by different shareholders. It would augur well for consistency if a qualitative criterion were framed in legal language to such an extent that would ensure more explicit identification and clarity of the “calibre” of persons that should be selected as company directors. Cadbury also argues that another advantage of self-regulatory approaches such as the corporate governance code is that its spirit can be invoked beyond its letter and that it can be swiftly adapted to suit new developments.²³⁰ There are certainly advantages to having self-regulatory codes,²³¹ but that should not preclude the existence of statutory regulation in cases where it is deemed more effective and necessary.²³²

In relation to the role of law, Hansmann & Kraakman point out that as a normative matter, the overall objective of corporate law, as of any branch of law, is to serve the interests of society as a whole.²³³ Chip Pitts argues that corporate leaders continue to affirm that

²²⁸ See Cadbury, *ibid*

²²⁹ See Cadbury, *ibid*

²³⁰ See Cadbury, *ibid*

²³¹ Considering that business men prefer to regulate themselves (see Du Plessis, note 50 at 48), self-regulatory codes might engender more acceptability and compliance, and in certain cases such as in corporate governance where one size does not usually fit all types of companies, the flexibility of such codes is an advantage. For a more detailed discussion on the advantages of self-regulation, see I. Bartle & P. Vass, *Self-Regulation and the Regulatory State: A Survey of Policy and Practice*, Research Report 17, Centre for the Study of Regulated Industries (CRI), University of Bath School of Management, October 2005, 35-38; see also A. Ogus, ‘Rethinking Self-Regulation’ (1995) 15 *Oxford Journal of Legal Studies* 97, where the advantages of self-regulation are argued to include reduced costs in relation to promulgation and interpretation, as well as savings in terms of administrative costs and timeliness as regards amendments.

²³² See Ferran, (note 215) 387; There are also clear disadvantages to having self-regulatory codes, see <http://www.bis.gov.uk/policies/bre/alternatives-to-regulation/self-regulation/self-and-co-regulation-pros-and-cons> (accessed 15th June 2012).

²³³ See H. Hansmann & R. Kraakman, ‘What is Corporate Law?’ in R. Kraakman, P. Davies, H. Hansmann, G. Hertig, K. Hopt, H. Kanda & E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: Oxford University Press 2004) 1-19 at 18.

corporations also serve public purposes intended to benefit society as a whole.²³⁴ He also asserts that enlightened companies increasingly understand that reasonable regulation is indispensable to effectively functioning sustainable markets.²³⁵ Therefore, it is in the best interests of society that companies are well governed in order that they achieve the objectives for which they were incorporated. In analysing the arguments for and against entrusting the regulation of companies to the markets, Ferran points out that there is recognition of imperfection in the markets particularly as regards information asymmetries, and market participants may find it difficult to accurately assess the risks they take in dealing with companies.²³⁶ She also states that arguments to justify statutory intervention include the fact that legal rules provide default standards which can reduce transaction costs and the State may also intervene on public interest grounds where activities raise concerns which cannot be adequately addressed through market mechanisms.

Regarding how regulatory intervention addresses the issue of personality and behavioural risks at present, there are existing legal rules designed to check the behaviour of corporate officers to varying degrees and in different situations. Examples in the UK include sections 1-9 of the Company Directors Disqualification Act 1986 and sections 171-177 of the UK Companies Act 2006.²³⁷ However, these provisions do not relate specifically to personality issues. Again, even in the areas to which they relate, the provisions are mostly reactive in nature and take effect after the fact. Hicks observed that the aims and objectives of disqualification of directors is the protection of the public interest by prohibiting unfit directors from managing limited companies, deterring improper conduct of directors, and establishing standards of good practice in the management of companies.²³⁸ However, the National Audit Office (NAO) report in 1999 concluded that the legislation though efficiently enforced has only a marginal effect on improving the behaviour of directors.²³⁹ One reason for that might be the impact of personality on behaviour and the fact that disqualification

²³⁴ See J.W. Chip Pitts, 'Corporate Social Responsibility: Current Status and Future Evolution' (2009) 6(2) *Rutgers Journal of Law & Public Policy* 334-433, at 344-345.

²³⁵ See Chip Pitts, *Ibid* 415.

²³⁶ See Ferran, (note 215) 387.

²³⁷ Sections 1-9 of the Company Directors Disqualification Act deals with disqualification of directors for reasons such as persistent breaches of companies legislation, fraud, and unfitness whilst sections 171-177 of the Companies Act deals with the duties of directors. These include the duty to act within powers, to exercise reasonable care, skill and diligence and to avoid conflicts of interest.

²³⁸ See A. Hicks, 'Director Disqualification: Can it Deliver?' (2001) *Journal of Business Law* 433-460.

²³⁹ See The NAO Report, 1999.

rules apply after the fact.²⁴⁰ Hicks rightly noted that the unfit directors are only discovered and dealt with after running a company into insolvency and having caused damage to creditors.²⁴¹ He also argues that another obvious gap in the disqualification net is that only those companies that go into formal insolvency proceedings are subject to investigation and unfit conduct reports by receivers or liquidators.²⁴² Therefore, in relation to companies outside this cadre, the disqualification rules are completely irrelevant.

As was stated earlier, the UK Companies Act 2006 does not contain provisions relating to qualifying criteria for directors except as regards minimum age.²⁴³ There are no provisions which deal with the personality of company directors. Provisions such as those in sections 171-177 relating to the duties of directors are ordinarily expected to influence the behaviour of directors. But, a recent survey of the impact of the UK Companies Act 2006 since its promulgation reports that there is a need to further clarify the duties of directors and provide guidance in order to increase behavioural change.²⁴⁴ This is an indication of the fact that there has been no overwhelming evidence of improvement in the behaviour of directors since the Act came into force. The absence of a definitive behavioural change based on the current provisions of the Act as it relates to directors' duties is not surprising because, hypothetically, the Act is applicable to the same directors that were managing companies before the Act came into force and the provisions of the Act would not ordinarily change their personality. For the reason that their personality influences their behaviour, if their personality remains the same, then their behaviour can be expected to remain the same. Also, the wording of the provisions of section 172 of the Act, for instance, has been argued to indicate a personal and subjective judgement.²⁴⁵ This reinforces the argument that if there is no change in

²⁴⁰ Chapter five discusses personality and behaviour, and highlights that personality dimensions influence behaviour and remain relatively stable over time, so, hypothetically, disqualification rules would apply to persons who are prone to behave in the prohibited ways, and would not contribute towards improving behaviour because persons remain who they are in terms of their personalities.

²⁴¹ See Hicks, (note 238) 439.

²⁴² See Hicks, (note 238) 443.

²⁴³ See s 157 of the UK Companies Act 2006.

²⁴⁴ See the BIS Review of the UK Companies Act 2006 at <http://www.bis.gov.uk/assets/biscore/business-law/docs/e/10-1362-evaluation-companies-act-2006-executive-summary.pdf> (accessed 15th June 2012).

²⁴⁵ Section 172 of the UK Companies Act 2006 provides that a director of a company must act in the way "he considers" would be most likely to promote the success of the company. See A. Keay, 'Section 172 (1) of the Companies Act 2006: An Interpretation and Assessment' (2007) 28(4) *Company Lawyer* 106-110; see also D. Fisher, 'The Enlightened Shareholder-Leaving Stakeholders in the Dark: Will Section 172 (1) of the Companies Act 2006 make Directors Consider the Impact of their Decisions on Third Parties' (2009) 20(1) *International Company and Commercial Law Review* 10-16; see also S.F. Copp, 'S. 172 of the Companies Act Fails People and Planet?' (2010) 31(12) *Company Lawyer* 406-408; see also the cases of *Re Southern Counties Fresh Foods Ltd* [2008] EWHC 2810; *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526; *People & Planet v HM Treasury* [2009]

personality, then the provisions of section 172 cannot reasonably be expected to change the behaviour of company directors.

Again, sections 386-389, 393 and 414 of the 2006 Act in relation to keeping proper accounts are also largely reactive in terms of mandating appropriate behaviour. The civil and criminal liabilities take effect after the offence has been committed. Ideally, the provisions should also act as deterrence, but the extent to which civil and criminal sanctions deter inappropriate behaviour is debatable considering examples of corporate failures, and the literature on personality and criminology,²⁴⁶ a recent example of this issue being the Lehman Brothers bankruptcy. The Sarbanes-Oxley Act in the US had mandatory provisions relating to the use of off balance sheet instruments and clearly provides for personal liability for contravention of the provisions of the Act but that did not deter the company directors at Lehman Brothers from contravening those provisions.²⁴⁷ The Sarbanes-Oxley Act in itself has been described as a reactive and poorly considered piece of legislation.²⁴⁸ However, its provisions are legally binding on company directors as it is still in force. An important issue in relation to securing the effectiveness of regulation is to ensure as much as possible that the regulated would abide by its provisions, and not rely solely on the deterrence element of sanctions where applicable. In the absence of a system which ensures that regulation is complied with, there are chances that effectiveness would be undermined.

Drew & Kendrick argue that poor corporate governance is a major source of enterprise risk.²⁴⁹ Considering that the personality and behaviour of directors are issues which can contribute to poor corporate governance and in the quest to manage corporate risks effectively, it is necessary to adopt risk management approaches which would yield the desired results and this includes statutory regulation. Arguments in favour of statutory regulation include the fact that legal rules provide certainty and predictability, exude democratic legitimacy and are better enforced as against market based self-regulation which

EWHC 3020, in which it was re-iterated that the judgment to be made as regards the application of s 172 of the UK Companies Act 2006 is a subjective one, and the issue to be considered is whether the directors acted in ways they personally believed would promote the success of the company.

²⁴⁶ See the discussions in chapters four; five and six, see particularly in chapter six, note 711.

²⁴⁷ See the Lehman Examiners Report, (note 131).

²⁴⁸ See R. Romano, 'The Sarbanes-Oxley Act and the Making of Quack Corporate Governance' (2004) *European Corporate Governance Institute (ECGI) Finance Working Paper No 52/2004*; see also L.E. Ribstein, 'Market versus Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002' (2002-2003) 28 *Journal of Corporation Law* 1.

²⁴⁹ See Drew & Kendrick, (note 166).

has been said to lack teeth.²⁵⁰ Nevertheless, it is vital to engage with the various regulatory theories in the development of a regulatory framework in order to harness the most beneficial aspects of the different theories and utilize them in the formulation of a regulatory policy that would be effective, efficient and sustainable.

2.9 CONCLUSION

This chapter has reviewed the relevant literature in the areas which are at the heart of this thesis. The issues highlighted in this literature review form the basis of the thinking upon which arguments in support of this thesis are developed in subsequent chapters. From this literature review, a background is provided for the development of a conceptual framework surrounding the specific problem and solutions addressed in the thesis. This review brings clarity and focus to the issue of personality and behavioural risk in corporate governance, having discussed literature highlighting the meaning of companies and corporate governance, the role of company directors, the impact of their personality and behaviour in relation to the management of companies and corporate failures, the import of risk and risk management, and regulatory intervention as a possible risk management approach. The analysis of literature in this chapter particularly lends credence to the major argument in this thesis which is that the personality of company directors contributes significant risks to the corporate governance process, and there is a need to explore effective means of mitigating these risks.

²⁵⁰ See Ferran, (note 215) 400-409.

CHAPTER THREE

RISK AND CORPORATE GOVERNANCE

3.1 INTRODUCTION

It has been highlighted in the two previous chapters that personality and behavioural issues represent risks which should be engaged with by the corporate governance process. The aims of this chapter are firstly, to provide a context for the term “risk” as used in this thesis. Secondly, it discusses the import of risk management as a concept, as well as providing a historical analysis of the manner in which risk and risk management have been approached and dealt with in corporate governance. Thirdly, it examines current corporate governance mechanisms and evaluates the extent to which they identify and manage personality risk. In discussing these issues, this chapter identifies that personality risk qualifies as a significant risk issue because of its potential effect on the behaviour of directors who are subject to corporate governance processes, and that behavioural risks are not effectively managed under existing corporate governance mechanisms. This is because there is no framework to enable the identification and in turn management of personality risk, which is a core element of behavioural risk. This chapter also illustrates that there are attempts to manage behavioural risks in corporate governance, but these attempts have omitted an essential element which impacts on behaviour, and that is personality. It is also evidenced in this chapter that the management of behavioural risk becomes ineffective if the elements which contribute to the risk, such as personality, and its associated risk elements remain unidentified and unmanaged. A detailed discussion on the relationship between personality and behaviour is undertaken in chapter five.

3.2 RISK

The meaning of the term “risk” has been traced to Arabic, Latin and Greek origins; and generally referred to chances of outcomes whether positive or negative.²⁵¹ The English word in itself was derived from the French word *risque* which has mostly negative but sometimes positive connotations.²⁵² Over time, the connotation associated with risk has become that of negativity, particularly the chances of occurrence of undesirable outcomes.²⁵³ There is no

²⁵¹ See Merna & Al-Thani, (note 167).

²⁵² Ibid.

²⁵³ See F. Wharton, *Risk: Analysis, Assessment and Management*, (Chichester: John Wiley & Sons 1992).

singly accepted definition of the term, but the numerous definitions of risk provide an indication of its connotation.²⁵⁴ Risk has been variously defined as the potential for unwanted negative consequences of an event or activity;²⁵⁵ the chancing of a negative outcome;²⁵⁶ the numerous types of threats caused by environment, technology, humans, organisations, politics etc.;²⁵⁷ a probability or threat of a damage, injury, liability, loss or other negative occurrence that is caused by external or internal vulnerabilities, and that may be neutralised through pre-emptive action;²⁵⁸ a measurable uncertainty;²⁵⁹ events with a negative impact which can prevent value creation or erode existing value;²⁶⁰ the probability of an adverse outcome;²⁶¹ a set of scenarios, each of which has a probability and a consequence;²⁶² a situation involving exposure to danger;²⁶³ uncertainty about and severity of the consequences of an activity with respect to something that human beings value;²⁶⁴ the possibility of deviation in the results from expected goals;²⁶⁵ the effect of uncertainty on objectives, whether positive or negative;²⁶⁶ and peril, danger, the chance of loss or injury.²⁶⁷

These definitions mostly highlight the fact that risk connotes the possibility of an outcome which is undesirable, unexpected, unwanted and therefore elicits the need to be influenced by prevention or minimisation of its effects. From the above, it can be gleaned that risk is a term which refers to the potentiality of negativism resulting from actions and inactions. There can be overlaps between the use of the terms “risk” and “uncertainties”, but generally risk is particularly used to denote situations where the probability of outcomes is known whereas

²⁵⁴ See O. Renn, ‘Three Decades of Risk Research: Accomplishments and Challenges’ (1998) 1(1) *Journal of Risk Research* 49-71.

²⁵⁵ See Rowe, (note 164).

²⁵⁶ See N. Rescher, *Risk: A Philosophical Introduction to the Theory of Risk Evaluation and Management* (Lanham, MD: University Press of America 1983).

²⁵⁷ See Agrawal, (note 165).

²⁵⁸ See the Business Dictionary <http://www.businessdictionary.com/definition/risk.html> (accessed 15th June 2012).

²⁵⁹ See Knight, (note 163) s I.I.26.

²⁶⁰ See The COSO Enterprise Risk Management Framework, (note 175) Executive Summary, p 2.

²⁶¹ See J.D. Graham & J.B. Weiner, *Risk versus Risk: Trade-Offs in Protecting Health and the Environment* (Cambridge: Harvard University Press 1995).

²⁶² See S. Kaplan, ‘Risk Assessment and Risk Management: Basic Concepts and Terminology’ in *Risk Management: Expanding Horizons in Nuclear Power and Other Industries* (Boston, MA: Hemisphere Publishing Corp. 1991) 11.

²⁶³ See the Oxford English Dictionary <http://oxforddictionaries.com/definition/risk> (accessed 15th June 2012).

²⁶⁴ See T. Aven & O. Renn, ‘On Risk Defined as an Event where the Outcome is Uncertain’ (2009) 12(1) *Journal of Risk Research* 1-11.

²⁶⁵ See T.J. Crowe, P.M. Fong, T.A. Bauman & J.L. Zayas-Castro, ‘Quantitative Risk Level Estimation of Business Process Reengineering Efforts’ (2002) 8(5) *Business Process Management Journal* 490-512 at 490.

²⁶⁶ See The International Organisation for Standardisation (ISO) 31000-*Risk Management-Principles and Guidelines on Implementation*, 2009.

²⁶⁷ See the legal definition of risk at <http://law.yourdictionary.com/risk> (accessed 15th June 2012).

uncertainties refer to cases in which the consequences of actions as well as the probability of occurrence is relatively unknown.²⁶⁸ For instance, there is a probability of death or injury resulting from drunk driving and so that risk can be identified and managed by establishing regulations to protect against it. However, there might be no reasonable probability of the effects of a natural disaster and the extent of its consequences as those situations are usually uncertain.

The connotation which is ascribed to terms can also depend on the context and so people may view risks and uncertainties differently depending on their situation.²⁶⁹ Risk can also be classified and framed in various ways, one of which is the origin.²⁷⁰ Therefore financial risks may be so called because they originate from financial issues, and likewise personality risks may be so called as they originate from personality issues. Classification of risk types and sources is essential for directing the priorities and attention of risk managers and for developing models for risk management.²⁷¹ The causes of risk may also be complex and interrelated.²⁷² It is therefore vital to ensure that risks which are interrelated are managed accordingly, as that is one way to generate overall effectiveness in the risk management process.

3.3 RISK MANAGEMENT

Risk management is the human activity which integrates the recognition and identification of risk, assessment of risk, developing strategies to manage risk and mitigation of risk using managerial resources.²⁷³ Risk management enables company management to deal effectively with identifiable events that can have an adverse effect on the company.²⁷⁴ Incorporating the definition of management as the planning, organisation, coordination, control and direction of resources toward defined objectives, and the meaning ascribed to risk, risk management has also been explained as the identification, assessment and prioritization of risks followed by coordinated and economical application of resources to minimise, monitor and control the

²⁶⁸ See Knight, (note 163).

²⁶⁹ See Z. Shapira, *Risk Taking: A Managerial Perspective* (New York: Russell Sage Foundation 1995).

²⁷⁰ See Drew & Kendrick, (note 166) 21.

²⁷¹ See Drew & Kendrick, (note 166) 22.

²⁷² See Drew & Kendrick, (note 166) 32.

²⁷³ See R.C. Agrawal, (note 165); see also O'Reilly, (note 168); see also Waring & Glendon, (note 168).

²⁷⁴ See C. Van der Elst & M. Van Daelen, 'Risk Management in European and American Corporate Law' (2009) ECGI Working Paper no 122/2009 <http://ssrn.com/abstract=1399647> 7 (accessed 15th June 2012).

probability and/or impact of unfortunate events.²⁷⁵ Risk management covers all the processes involved in identifying, assessing and judging risks, assigning ownership, taking actions to mitigate or anticipate them, and monitoring and reviewing progress.²⁷⁶ From the definitions and explanations of what risk management entails, it becomes evident that the first step in risk management is the identification of risk itself. Arguably, risk can only be managed when it has been identified. Considering the meaning of risk as the potential for a negative outcome, it is therefore a risk in itself for a risk element to be unidentified, as that would mean that the chances of effective assessment and management are reduced, if existent at all. After identification, risk assessment and risk management processes follow. The issues involved in risk assessments and analysis are as follows:

- i) Defining the undesirable outcome
- ii) Identifying the probability of occurrence
- iii) Measuring the consequences/severity of impact of occurrence²⁷⁷

In the light of what risk connotes as evident from the various definitions of risks, and the knowledge of the processes involved in risk identification and management as discussed above, a review and discussion of risk perceptions and risk management approaches in corporate governance will then be undertaken, in order to assess whether and how corporate governance mechanisms have managed personality and behavioural risks.

3.4 RISK, PERSONALITY AND BEHAVIOURAL RISK IN CORPORATE GOVERNANCE

THE TURNBULL GUIDANCE, INTERNAL CONTROL AND RISK MANAGEMENT

The first attempts at bringing risk issues into focus in corporate governance recommendations can be seen in sections 4.31 and 4.32 of the Cadbury Report dealing with internal control. The Cadbury Committee was set up in response to perceived problems in the financial aspects of corporate governance in the early 1990s and corporate failures in the UK expanded

²⁷⁵ See D. W. Hubbard, *The Failure of Risk Management: Why it's Broken and How to Fix it* (Hoboken, New Jersey: John Wiley & Sons 2009) 46.

²⁷⁶ This definition is provided by the HM Treasury Website http://www.hm-treasury.gov.uk/psr_governance_risk_definitions.htm (accessed 15th June 2012).

²⁷⁷ See S. Kaplan & J. Garrick, 'On the Quantitative Definition of Risk' (1981) 1(1) *Risk Analysis* 13; see also Merna & Al-Thani (note 167) 12.

the remit of the committee.²⁷⁸ The internal control provisions in the Cadbury Report state that directors are responsible under the Companies Act for maintaining adequate accounting records and to meet these responsibilities the directors need in practice to maintain a system of internal control over the financial management of the company, including procedures designed to minimise the risk of fraud. The provisions also recommended that directors should make a statement in the report and accounts on the effectiveness of their system of internal control and auditors should report thereon. These provisions did not elicit a high level of compliance as far as reporting was concerned because they appeared vague and left company boards in confusion as to what was required of them in relation to internal control.²⁷⁹ Risk management was as yet not spelt out in the recommendations.

In 1994, the Rutteman Committee attempted an explanation of what the internal control provisions entailed by stating in their report that internal financial control connotes “the internal controls established in order to provide reasonable assurance of (a) the safeguarding of assets against unauthorised use or disposition; and (b) the maintenance of proper accounting records and the reliability of financial information used within the business or for publication”.²⁸⁰ The Hampel Committee Report, and the Combined Code on Corporate Governance which followed, elaborated more on the issue of internal control and risk management.²⁸¹ The Combined Code stated explicitly in Principle D.2 that “The board should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets”. The Code also stated in Provision D.2.1 that “The directors should, at least annually, conduct a review of the effectiveness of the group’s system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management”.²⁸² So, the concept of risk management was spelt out in the 1998 Combined Code, even though there was still no provision on how it was to be achieved. In 1999, the Turnbull Committee provided much needed guidance on the issue of risk first articulated by the Cadbury Committee by explicitly identifying the elements of a sound system of internal control and

²⁷⁸ See The Cadbury Committee Report, *The Financial Aspects of Corporate Governance*, 1992, s 2.1 & 2.2 <http://www.ecgi.org/codes/documents/cadbury.pdf> (accessed 15th June 2012).

²⁷⁹ See M. Power, *The Audit Society* (Oxford: Oxford University Press 1997) 55.

²⁸⁰ See The Rutteman Report-*Internal Control and Financial Reporting: Guidance for Directors of Listed Companies Registered in the UK*, ICAEW, London, 1994.

²⁸¹ See The Hampel Report-*Final Report-Committee on Corporate Governance*-January 1998; see also The Combined Code on Corporate Governance, June 1998.

²⁸² See similar provisions in Principle C.2.1 of the UK Corporate Governance Code, 2010.

recommending processes through which company boards could fulfil their reporting responsibilities in this regard.²⁸³ The Turnbull Report also highlighted the relationship between internal control and risk management by stating that “A company’s system of internal control has a key role in the management of risks that are significant to the fulfilment of its business objectives”.²⁸⁴ This connotes that risks in a company would vary across different parameters depending on the company’s business objectives, and internal control is one important means of managing significant risks. The statement also lends credence to the definitions of risk earlier discussed to the extent that if fulfilling its business objectives is the aim of any company, then any event that goes against the achievement of that objective is a risk to it.

The Turnbull Guidance was reviewed in 2005 by a group set up by the FRC (Financial Reporting Council) and chaired by Douglas Flint.²⁸⁵ The Revised Guidance states that “A company’s objectives, its internal organisation and the environment in which it operates are continually evolving and, as a result, the risks it faces are continually changing. A sound system of internal control therefore depends on a thorough and regular evaluation of the nature and extent of the risks to which the company is exposed. Since profits are, in part, the reward for successful risk-taking in business, the purpose of internal control is to help manage and control risk appropriately rather than to eliminate it.”²⁸⁶ This presupposes that risk management efforts from the perspective of internal control are not aimed at a complete elimination of risk since entrepreneurial endeavour is an exercise which involves elements of risk. It has also been argued that risk management in itself must take cognisance of the fact that risk is inherent in business and risk reduction is practical only up to a point.²⁸⁷ The aim should therefore be to manage risks up to a practicable level. In para 19 of the Guidance, elements of a sound system of internal control are outlined and these include policies, processes, behaviours, tasks etc. that facilitate the effective and efficient operation of a company by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company’s objectives.²⁸⁸ Internal

²⁸³ See The Turnbull Guidance, (note 169).

²⁸⁴ See The Turnbull Guidance, Ibid 4.

²⁸⁵ See The Revised Turnbull Guidance, (note 170).

²⁸⁶ See The Revised Turnbull Guidance, Ibid 3.

²⁸⁷ See Hubbard, (note 275).

²⁸⁸ See The Revised Turnbull Guidance, (note 170) 7.

control systems also encompass mechanisms which help to ensure the quality of internal and external reporting; and this requires the maintenance of proper records amongst other issues.

The Treadway Commission had also defined internal control as a process designed to provide reasonable assurance regarding the achievement of objectives in the categories of effective and efficient operations, reliability of financial reporting and compliance with applicable laws and regulations.²⁸⁹ Internal control systems should also help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.²⁹⁰ Internal control is, therefore, propagated in the Turnbull Guidance as a mechanism which is aimed at managing the risks which a company faces in the achievement of its objectives, and it should facilitate the overall effective and efficient operation of the company. Consequently, internal control should encompass all the elements which are geared towards ensuring that the actions and decisions taken within the company are in consonant with the corporate objectives. It is argued that should also include controlling the risks which accrue from the persons who are taking these actions and making these decisions.

Interestingly, in para 22, the Guidance states as follows “A sound system of internal control reduces, but cannot eliminate, the possibility of poor judgement in decision-making; human error; control processes being deliberately circumvented by employees and others; management overriding controls; and the occurrence of unforeseeable circumstances”.²⁹¹ So, in effect, even though a sound system of internal control is supposed to help reduce the occurrence of events such as those stated in para 22, it cannot eliminate them. That is very much in keeping with the idea of risk management in the first place as is envisaged by the Guidance. However, most of the issues highlighted in para 22 relate to deliberate human behaviour which as will be seen in subsequent chapters emanate predominantly from personality issues, and for the purposes of this thesis, the important factor is whether internal control mechanisms are actually helping, and to what extent, to manage these sort of risks which can be categorized as personality risks.

Analysing para 22 alongside para 19, one begins to identify a situation in which the success of internal control systems mechanisms can, to a large extent, be dependent on the personality

²⁸⁹ See COSO-*Internal Control-Integrated Framework*, Executive Report, 1992.

²⁹⁰ See The Revised Turnbull Guidance, (note 170) 7.

²⁹¹ Ibid.

of the users. For instance, if there are systems in place which are aimed at ensuring the accuracy of reports such as mandatory compliance with applicable laws and regulations in relation to such reports, it may not help to reduce the incidences of inaccurate reports if the company directors who are involved in that activity are persons who are prone to contravening applicable laws and regulations. As was stated in para 22, internal control mechanisms may not eliminate the possibility of control processes being circumvented and management overriding controls. However, these circumstances of circumvention are significant risks in themselves which must be managed because they impact on the achievement of corporate objectives. Para 19 seems to place the focus of internal control particularly on business, operational, financial and compliance risks, even though it mentions “other risks”. Personality risks are an issue in all of those areas because people are involved in taking actions and decisions in those areas. The central issue here is that personality risks are not explicitly catered for under the Turnbull Guidance, and even though arguments may be made that it could be implied, the fact that the issue is not clearly elucidated makes it impossible to identify personality risks appropriately and develop mechanisms for managing those risks effectively.

It has already been noted that internal control and risk management and all they entail was not explicitly spelt out in the Cadbury Report through to the Hampel Report, and that situation made the articulation of internal control and risk management processes difficult in practice as well as for reporting purposes until the Turnbull Guidance was promulgated. Therefore, supposedly, one goal of the Turnbull Guidance was to elucidate in totality what internal control and risk management should entail, and it has done so, without particularly identifying personality risks as a distinct and significant risk parameter. It does, instead, provide the indication in para 22 that personality risks may not be effectively managed under regular internal control processes and rightfully so as will be made evident from examples of corporate failures in which controls were actually circumvented by company directors. The Turnbull Guidance is simply guidance, and there is a possibility that some companies may identify personality risks within their own risk analysis exercise. However, the issue is that the guidance is meant to serve as a standard for all relevant companies to follow. Therefore, if the issue of personality is not appropriately addressed in the guidance, then there is a risk that it will not be addressed by the companies that are required to follow the guidance. Corporate governance codes and guidance are meant to elucidate acceptable standards for companies to follow. These codes and guidance are promulgated through a system which

draws on consultations and consensus from the business community and in the process creates standards which can be viewed as the most reasonably acceptable requirements in relation to the issues in question.²⁹² It is therefore possible that companies have not considered personality risks as an important issue. Even if companies assumed a definition of personality risk which placed it within the parameters of the other risks clearly articulated in the Turnbull Guidance, or placed it within the ambit of “others”, then it would be a case of different companies articulating different responses to personality risks without any specific guidance; a situation which is likely to result in a potential risk of mismanagement of those risks. Moreover, as will be illustrated in the next chapter in relation to corporate failures and the ensuing reports thereon, there is no clear evidence that companies have attempted to articulate and manage personality risks appropriately, particularly in relation to company directors.

In relation to questions as to whether internal control processes as envisaged by the Turnbull Guidance actually manage personality risks, the answer would be negative. The internal control and risk management process provided for in the Turnbull Guidance does not deal with personality risk as an issue vital to the management of the kind of risks envisaged under para 22 and, for that reason, all other internal control processes aimed at reducing the possibility of occurrences of those sort of situations would not be as effective as they should be because personality which is a fundamental element that brings about the occurrence of those situations has not been dealt with appropriately. From the explanation in relation to risk analysis in the earlier sections of this chapter, there must be an identification of the source of risk for there to be a meaningful attempt at assessing it and managing it. Therefore, if internal control systems have not identified personality risks explicitly as a distinct and significant risk source, then there are flaws in the system. The aim of developing internal control processes should be to ultimately engender the creation of efficient and effective corporate governance, and any issue that impacts on the achievement of this aim can be viewed as a risk source. A risk source which is significant to the attainment of the overall corporate objective and remains unmanaged is a vital gap in the risk management process.

²⁹² For instance the Cadbury Committee was set up by the London Stock Exchange and the accountancy profession. The Financial Reporting Council (FRC) still consults with the business community in relation to reviews of the governance codes; see the companies consulted in the most recent review in 2009 at <http://www.frc.org.uk/corporate/2009DecConsultationamendments.cfm> (accessed 15th June 2012).

The following diagram illustrates the flow of the risk management process as envisaged by the Turnbull Guidance, with an indication of the gap created by the absence of personality risk management, as well as the possible impact.

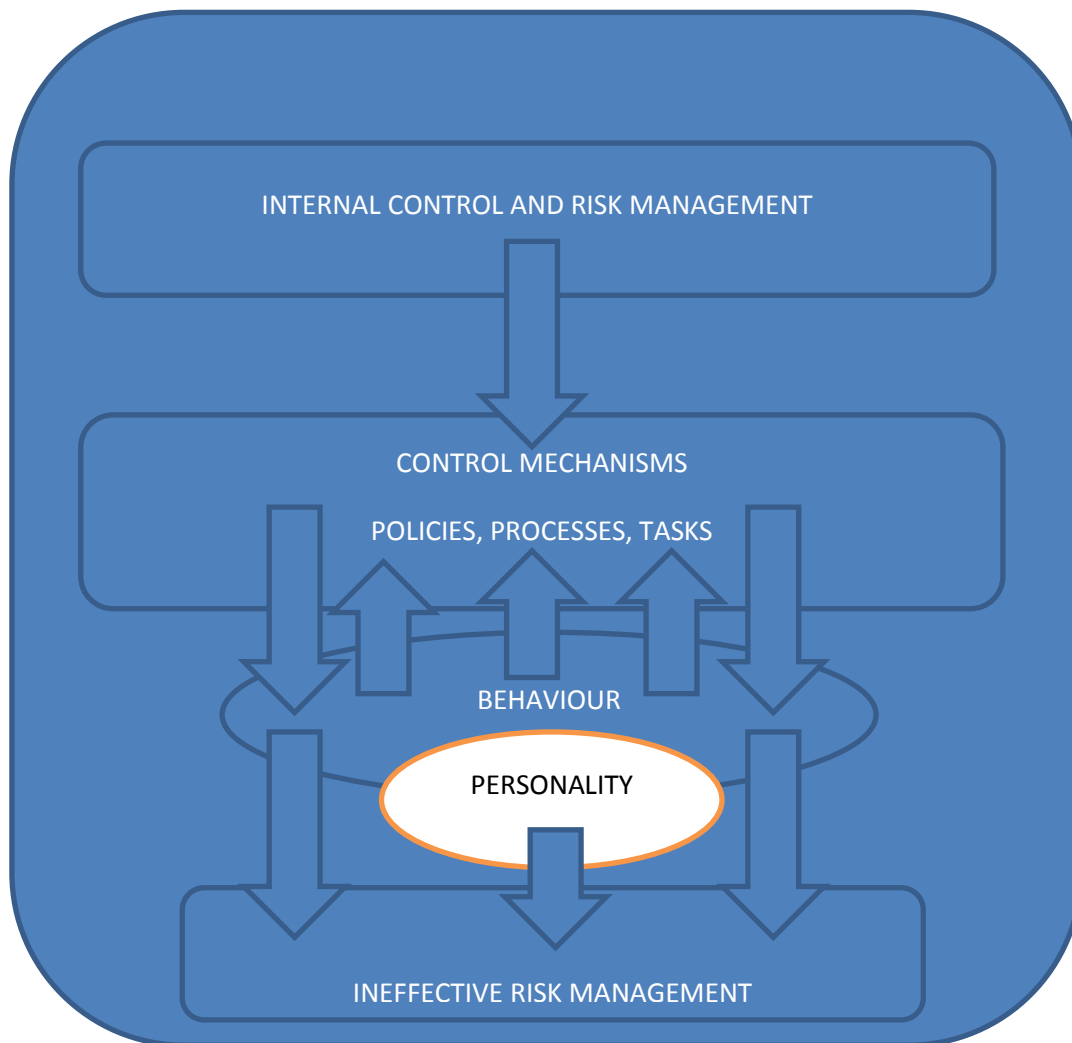


Figure 1 above illustrates the flow of the risk management process in corporate governance, and indicates that there is an impact of behaviour on control processes and vice versa, highlighting the gap created by non-existent personality risk management and the possibility of overall ineffective risk management.

In relation to behavioural risks in general, it is possible that internal control processes are aimed at managing those risks to the extent that controls are supposed to act as checks on

behaviour.²⁹³ However, the pivotal argument here is that if controls can be circumvented, then they cannot in effect be the most effective and sole means of managing behavioural risks, as well as all other corporate risks. Considering that there are factors which influence and impact on behaviour, one of the most significant ones being personality, there can be no meaningful attempt at managing behavioural risks without a meaningful attempt at identifying and managing personality risks. Controls are nonetheless necessary in corporate risk management because they are designed to cater for varying situations which the company directors are faced with, and it is the case that perhaps in the absence of adequate controls and guidance, even the best of directors may be at a loss regarding what actions and decisions to take in certain situations.²⁹⁴ However, having controls alone as envisaged by the Turnbull Guidance, without dealing with personality risks, would not suffice if overall effective risk management is sought. It has been acknowledged that there is a level of subjectivity in risk assessment which results from issues such as the personal objectives, perspectives and underlying values of the person engaged in the risk management activity.²⁹⁵ Therefore, since personality has an influence on these issues, it follows that the personality of company directors would definitely impact on their assessment and management of risk in every area of the business, and there is then a risk that these personality issues might override any objective controls in place if personality risks are not in themselves managed.²⁹⁶

Managing personality risks with the use of internal controls would require specific knowledge regarding the personality of company directors, so as to permit the creation of internal control processes which would be fit for the purpose.²⁹⁷ One size may definitely not fit all companies in this case, and particularly for the sake of efficiency, it would be reasonable to apply minimum controls where it is safe to do so and adopt more stringent measures where necessary. This would be beneficial for a company which seeks to generate profit by reducing cost, as well as minimise losses and derailment from its corporate objective by fostering an effective risk management system. Applying controls in a situation where the personality of a director is unknown and unmanaged is simply increasing the

²⁹³ Para 19 of the Revised Turnbull Guidance indicates that internal control should prescribe behaviours which facilitate the effective operation of a company.

²⁹⁴ For instance, the failure of the Italian company Parmalat illustrates how necessary financial controls are. See R.Y. Roberts, R.P. Swanson & J. Dinneen, 'Spilt Milk: Parmalat and Sarbanes-Oxley Internal Control Reporting' (2004) 1(3) *International Journal of Disclosure and Governance* 215-225.

²⁹⁵ See A.J. Hatfield & K.W. Hipel, 'Risk and Systems Theory' (2002) 22(6) *Risk Analysis* 1043-1057 at 1048.

²⁹⁶ Chapter five discusses the influence of personality on actions and decisions in more detail.

²⁹⁷ This is the risk identification aspect as required in an effective risk management process.

uncertainties surrounding the effectiveness of those controls.²⁹⁸ It then means that in relation to managing all other corporate risks, effectiveness may not be achieved because the underlying personality risks have not actually been managed effectively. Personality risks are, therefore, foundational risks as they affect the success of every other risk management process. In this way, personality risks become highly significant in relation to the achievement of business objectives.

The other factor which could impact on behaviour is situations, but then, these are largely taken care of by controls,²⁹⁹ meaning that if situations are provided for by controls, that would leave the other significant element of behaviour which is personality to determine eventual outcomes. It then means that where controls are already in place, the other part of the equation which deserves attention and has not received it appropriately in corporate governance is actual personality issues. Still in relation to situations, when there are consequences for the contravention of controls, the issue of deterrence may influence the level of compliance with the control measures.³⁰⁰ However, one would be minded to argue that it is more effective to manage personality risks actively than to rely on the prospect of deterrence since that factor in itself would also be dependent on personality issues.³⁰¹ For instance, as regards the issue of compliance with established rules, it is acknowledged that rules may not always be obeyed and the personality of the person in question plays an important role in determining the probability of a rule being obeyed.³⁰² Again, where the gains of contravening controls outweigh the consequences of doing so from the perspective of the contravener, then the issue of deterrence becomes meaningless if the contravener is a person who is focused on the gains.³⁰³

In determining the gains of contravention, a contravener may also consider the risk of being caught, and the lower that risk, the lesser the effects of deterrence. Also, the gains of contravention might be viewed in relation to the value acquired or in terms of the likelihood

²⁹⁸ This argument is also made in the analysis of the FRC Report on Boards and Risk (discussed in detail in later part of this section) in relation to “net risks” and “gross risks”.

²⁹⁹ For instance in corporate governance, internal controls provide for specific situations in relation to operational risks, financial risks, etc. A company’s internal control process might specify that every single board member must approve investments above a certain monetary value, thereby aiming to manage risks in relation to that situation.

³⁰⁰ See J. Dine, (note 49) 128; see also note 711.

³⁰¹ See note 711

³⁰² See W. Brammertz, ‘Risk and Regulation’ (2010) 18(1) *Journal of Financial Regulation and Compliance* 46-55 at 51; see also note 711, highlighting criminology and psychology literature regarding the reasons why people obey and disobey rules.

³⁰³ See J.Q. Wilson & R.J. Herrnstein, *Crime and Human Nature* (New York: Simon and Schuster 1985).

of getting caught. For instance, if a person decides to commit fraud, the reasons why the consequences for the offence might not act as deterrence might lie in the fact that he/she expects to gain one million pounds and that supersedes any consequences; or he/she has considered that the risk of getting caught is so low that any amount of money gained as a result of the fraudulent activity would be worthwhile as there is a higher likelihood that the consequences of being caught would not even come into question. It may actually be profitable in certain cases to circumvent a control measure because of the value of the gains. However, the issue is that there are personalities who are more likely to do so than others, irrespective of any gains or the value of the gains.³⁰⁴ Even in the case that the consequences actually prove more detrimental than any possible gains, if a person is focused on the gains and not the consequences, it means that the gains would be the driving force behind the decision to contravene the control measure, and the deterrence factor of the consequences loses significance. Again, there may be persons who would focus more on the gains and others who would focus more on the consequences, and in the latter case the issue of deterrence becomes meaningful.³⁰⁵

Consequences for contravening controls could come in the form of financial detriment or physical detriment. Some persons would contravene controls simply as a result of their personality, irrespective of the losses which might arise as a result of the contravention.³⁰⁶ This would be one of the reasons why there are law breakers in prisons for offences which have long been spelt out in regulations with dire consequences. If deterrence was a concept that could have the same effect on every kind of individual, then laws for offences which have presumably appropriate detrimental consequences would never be contravened. Even if the impact of deterrence is dependent on the severity or nature of consequences, then it still means that different kinds of individuals would respond to the issue of deterrence in different ways. This is because there will be different perceptions of consequences, so for instance, a detriment which appears severe to one person may not do so to another. There is also the issue of stigma which may be attached to being found guilty of offences and might act as deterrent, but again, there will be different perceptions of its detrimental value and impact depending on the personality of the individual. Therefore, as the issue of deterrence is to an extent dependent on personality, then it is also a risk to rely on deterrence as a means of

³⁰⁴ See C. Crowther, *An Introduction to Criminology and Criminal Justice* (England: Palgrave Macmillan 2007) 281.

³⁰⁵ Ibid.

³⁰⁶ See Brammertz, (note 302); see also Wilson, (note 303); see also note 711.

managing behavioural risks, without considering personality issues. In effect, internal control processes and the consequences of contravening them which actually form part of the control process are made less effective without the appropriate management of personality risks.

The Turnbull Guidance indicates that corporate risks including business, operational, financial and compliance risks.³⁰⁷ Behavioural risk was highlighted implicitly with the indication that it may not be absolutely eliminated under the guidance, and internal control measures could reduce it. It is perplexing that the Turnbull Guidance simply refers to a reduction of the possibility of behavioural risks when it should be aiming to create a situation in which these risks are managed effectively. This is because if a reduction results in effective risk management, then that would suffice, but a reduction in the occurrence of a phenomenon may not equate to an effective result in relation to the problem as a whole. Internal control measures can only begin to manage behavioural risk effectively if those measures approach the problem in an appropriate manner, by identifying, assessing and managing the issues which create the risk in the first place. An issue which is not highlighted and provided for in a code or guidance, or other reference material for company directors stands minimal chances of being addressed adequately as there might be no clear standards to follow.

As is evidenced from the discussions above, corporate governance mechanisms have not provided adequately for the identification and management of personality risks, and in turn behavioural risks. It may have been an oversight over the years, due to the fact that behavioural issues have only become increasingly focused upon with the issue of recurring corporate failures attributable to inappropriate behaviour as indicated by the reports of investigations into failures which will be discussed in chapter four. It may also be the case that sufficient evidence was not historically available to establish a linkage between personality and behaviour in corporate governance. Again, personality might have been viewed as an abstract and qualitative issue, for which definitive control mechanisms might prove challenging. Personality risks might also have been viewed as insignificant in relation to other risks, especially in the light of internal control processes and other risk management systems, causing it to escape being framed as a distinct risk issue in relation to behaviour.

³⁰⁷ See the Revised Turnbull Guidance, (note 170) 7

Nevertheless, as made evident from psychological literature, personality dimensions can be identified, and so any associated risks can also be identified and managed.³⁰⁸

The approach that is adopted in the management of behavioural risk is an issue as much as the management of the risk itself. For instance, the adoption of a voluntary mechanism in the management of risks as against the establishment of a mandatory process is likely to impact on the overall effectiveness of the risk management process.³⁰⁹ Internal control mechanisms and other corporate risk management processes will be ineffective if they fail to identify and manage risks which have the potential to impact adversely on corporate objectives. Corporate failures are certainly not in the corporate plan of companies as objectives, and usually occur when corporate objectives are truncated. In relation to effectiveness, the COSO framework in analysing criteria for evaluating the effectiveness of an enterprise risk management framework highlighted eight elements which should be used as parameters for judgment as to effectiveness. The framework states as follows: “determining whether an entity’s enterprise risk management is “effective” is a judgment resulting from an assessment of whether the eight components are present and functioning effectively...for the components to be present and functioning properly, there can be no material weaknesses...”³¹⁰ These eight elements are internal environment, objective setting, event identification, risk assessment, risk response, control activities, information and communication, and monitoring.³¹¹ Therefore, in relation to effective risk management, an issue such as the identification of risk categories is central to the effectiveness of the entire regime. In the event that significant risk issues are omitted, ignored or unidentified, it is then arguable that material weaknesses exist in the components of the risk management process and render the entire process ineffective. This appears to be the case in respect of the treatment of personality risks in corporate governance. The absence of a framework for identifying and managing personality risks effectively in corporate governance is a significant risk to the entire governance process. This becomes even more important at a time when many boards are looking to develop new approaches to managing and monitoring their risks, focusing in particular on areas of change.³¹²

³⁰⁸ Discussions on personality dimensions and identification processes are undertaken in chapter five.

³⁰⁹ This is discussed in detail in chapter six.

³¹⁰ See the COSO Framework, (note 175) 5.

³¹¹ See the COSO Framework, (note 175) 3-4.

³¹² See the Grant Thornton Review, discussed in later section, (note 338) 20.

Interestingly, in one of the reports issued after the recent financial crisis, it was stated that the Turnbull Guidance does not provide a helpful approach to the mechanics of creating an effective and lasting risk management and assurance framework over the long term.³¹³ The report highlights that some of the problems of risk management which are not adequately addressed by guidance such as Turnbull include the fact that risks are frequently not linked to strategy and that risk definitions are often poorly expressed.³¹⁴ This is true because as noted in section 3.3, risk must necessarily be identified appropriately if it is to be managed effectively. Defining risk issues with clarity forms part of an adequate and effective identification process. In cases where risk issues are not identified effectively, there will be a negative impact on the entire risk management process. It becomes even worse for risk management outcomes if risk issues are not conceived of and identified at all, as is seemingly the case with personality risks. Also, another reason for this remark might be the fact that behavioural issues were at the forefront of the financial crisis, and the Turnbull Guidance has not adequately addressed the risks associated with behaviour.

The Turnbull Guidance provides in para 15 that the board of directors is responsible for the company's system of internal control.³¹⁵ It has also been asserted that the whole area of contemporary corporate governance hinges on the complexity of risk and understanding of risk by the board of directors.³¹⁶ The UK Corporate Governance Code has articulated an increasingly focused role for the board in relation to risk and risk management by stating that "The Board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems."³¹⁷ This means that boards of directors bear the primary responsibility for corporate risk management. The Financial Reporting Council (FRC) in 2011 sought to decipher how boards were engaging with their responsibilities in relation to risk assessments, management and reporting in line with the provisions of the new code and held a series of meetings with participants from major listed companies including chairmen, executive and non-executive directors, and heads of risk and internal audit, as well

³¹³ See Richard Anderson & Associates, *Risk Management and Corporate Governance*, OECD Report, 2009, 14.

³¹⁴ Ibid.

³¹⁵ See The Revised Turnbull Guidance, (note 170) 6. Interestingly, s 404 & 409 of The Sarbanes-Oxley Act 2002 in the United States has similar requirements for company management.

³¹⁶ See G. De Lacy, *How to Review and Assess the Value of Board Subcommittees* (Australian Institute of Company Directors 2005) 1-24 at 17.

³¹⁷ See The UK Corporate Governance Code, 2010, (Principle C.2).

as selected investors and advisers.³¹⁸ The report on the discussions highlights that one of the conclusions drawn was that the Turnbull Guidance was still broadly fit for purpose, but that a limited review would take place during 2012 to take cognisance of the role of the board as articulated in the UK Corporate Governance Code. The summary of the findings also highlights a number of issues relevant to this thesis, and these are discussed below.

Firstly, it is stated that boards needed to focus particularly on those risks which are capable of undermining the strategy or long-term viability of the company or damaging its reputation.³¹⁹ Personality risks are such that they may impact on all the actions and decisions emanating from company directors and therefore have potentially grave implications for the development of strategy which would ensure long-term viability of the company as well as its success. Secondly, the summary also states that a focus only on “net risk” could be dangerous and that it was essential that boards had a view on the company’s potential exposure to risks. Boards needed a view of the combination of risks (“gross risk”) before the application of risk mitigation policies in order to understand the effectiveness of those policies.³²⁰ Personality risks can be classed as elements which contribute to gross risks to the extent that they potentially impact on every other risk management and mitigation policy. For example, in a situation where the internal control processes provide for the approval of a transaction by two directors of the company with aim of ensuring that one is a check on the other, that concept in itself is risk managing the situation only to the extent that both directors do not connive to circumvent the process. If one director is faithful to the controls, then the risk management procedure is effective. But, if not, then it becomes ineffective. Therefore, in the consideration of the overall effectiveness of the risk management process, issues such as personality risks which could include the potential capability of the company directors and the likelihood of their being the kinds of persons who might connive to circumvent the process should also be taken into account when considering the effectiveness of the entire process. If those factors are considered, perhaps additional or different risk mitigating processes would then be viewed as more effective and necessary.

³¹⁸ See The Financial Reporting Council-*Boards and Risk: A Summary of Discussions with Companies, Investors and Advisers*-September 2011 (The FRC Report) <http://www.frc.org.uk/images/uploaded/documents/Boards%20and%20Risk%20final.pdf> (accessed 15th June 2012).

³¹⁹ See the FRC Report, Ibid 2.

³²⁰ Ibid.

Considering companies' approaches to risk, the FRC report notes that non-financial companies were having greater challenges in identifying and mitigating risks.³²¹ No particular reason was stated for this situation, but it can be argued that one reason may be that companies in the financial sector in the UK are regulated more intensely, and particularly have a more articulated process for risk management which includes the management of personality risks in the form of the FSA's Approved Persons Regime.³²² Therefore, it may be the case that the corporate officers in financial companies are better positioned to manage risks. Again, differences in risk management approaches may originate from the nature of goods and services provided by different kinds of companies, because for instance, a manufacturing company may be exposed to different types of corporate risks from those encountered by a financial investment company.

On the nature of risk, the FRC report highlights that participants discussed different categories of risks, grouping them predominantly under strategic and operational risks.³²³ Personality risk was not specifically referred to. This indicates that it was not highlighted by the participants as a risk category. It means that personality risk was not viewed as a source of concern to the participants because the reason for convening the meetings was to discuss how boards were engaging with risk management. Again, this illustrates the fact that personality risks are still not viewed as a distinct and significant risk category, and considering its impact on corporate governance, it should be so categorised to enable it to be dealt with effectively.³²⁴ It is interesting to note that the FRC report states that reputational risk was not considered as a separate risk category by the participants, but was instead considered as a consequence of the failure to manage other risks successfully.³²⁵ Likewise, personality risks underlie the management of all other risks, and failure to identify personality risks results in a situation where all other risks are not identified and managed sufficiently. This would be the case in corporate governance failures where internal controls were in existence but failures still occurred because the personality of company directors and the potential risks they bear was not identified and managed appropriately. Therefore, all other risk management processes stand the chance of failing on account of personality risks.

³²¹ See the FRC Report, Ibid 7.

³²² This regime is discussed in more detail in chapter seven.

³²³ See the FRC Report, (note 318) 8.

³²⁴ Chapters four and five illustrate the impact of personality risks in corporate governance more clearly, and establish the linkage between personality and behaviour, as well as the associated risks.

³²⁵ See the FRC Report, (note 318) 9.

In relation to risk and control culture, the FRC report states that participants agreed that it was important to embed the right culture across the company alongside any improvements in techniques and processes.³²⁶ They noted that good culture resulted in better judgment which reduces the reliance on processes.³²⁷ It is interesting to note the use of the word “culture” here, because culture is a phenomenon which also hinges on personality.³²⁸ So, in a way, there is recognition of the fact that having the appropriate personality dimension is vital in corporate risk management and is a factor in the effective and efficient functioning of processes. The FRC report also noted that it was essential that boards led by example and set the right tone as a means of influencing the behaviour of management and staff. This requires positive leadership from the chairman and chief executive in particular.³²⁹ This is an indication that ensuring that the board consists of appropriate personalities would have a trickle-down effect on risk and control culture across the company, because the behaviour of board members would influence the behaviour of other officers. The FRC report states that it was recognised that risk and control culture was one of the issues on which it was most difficult for boards to obtain assurance.³³⁰ One reason for this may be the lack of an appropriate and effective approach towards issues such as personality risks and its impact on behaviour which is invariably a contributory element towards the outcome of risk and control culture across the company.

Culture has been stated to be a vital aid to strategic risk management and the personality of company directors can create as well as shape organisational culture.³³¹ Aspects of culture that can particularly work against effective risk management would include unethical behaviour, propensity for excessive risk-taking and persecution of whistle-blowers.³³² In relation to public reporting, the participants who were investors noted that they relied more the assurances they received in their engagements with the board and management than on

³²⁶ See the FRC Report, (note 318) 12.

³²⁷ Ibid.

³²⁸ Organisational culture refers to the values and behaviours that contribute to the unique social and psychological environment of an organisation; see the Business Dictionary <http://www.businessdictionary.com/definition/organizational-culture.html> (accessed 15th June 2012); as personality is a significant element in relation to behaviour, it means that culture is influenced by personality.

³²⁹ See the FRC Report, (note 318) 12.

³³⁰ Ibid.

³³¹ See Schein, (note 140).

³³² See S.A. Drew, P.C. Kelley & T. Kendrick, ‘CLASS: Five Elements of Corporate Governance to Manage Strategic Risk’ (2006) 49 *Business Horizons* 127-138 at 130.

statements in the annual reports and this was particularly the case when it came to assessing the quality of risk management and internal control, for which their main source of assurance was the quality of the board.³³³ Again, the use of the word “quality” here would impliedly connote a board with appropriate personalities, as well as the relevant skills, experience and knowledge. Having appropriate personalities would contribute to the quality of the board because the board makes decisions and takes actions in supposed furtherance of corporate objectives, and as would be illustrated later in the thesis, personality impacts on behaviour and behaviour is the bedrock of decisions and actions.

In relation to the Turnbull Guidance, the FRC report highlights that the majority of participants were in favour of reviewing at least parts of the guidance for reasons which include that it did not adequately address cultural and behavioural issues.³³⁴ This is also a clear indication that behavioural issues are indeed increasingly viewed as problematic in corporate governance. The salient point however is that despite the attempts made at addressing the problem, which will be considered in chapter four, no definitive mechanism has been deployed which seeks to identify and articulate all of the issues surrounding behaviour, and there has been no clear elucidation of the relationship between personality and behaviour, and the related mechanisms of managing the risks associated with personality and behavioural issues. As was discussed earlier, a limited review of the Turnbull Guidance is planned by the FRC for later in 2012; however, the extent and details of that review are as yet unknown. Even though it has been acknowledged that the guidance is deficient in relation to how it addresses behavioural risks, it is still unknown whether personality risks and their relationship to behaviour is considered an issue in relation to behavioural risks as that much was not stated in the FRC report.³³⁵

3.5 THE UK CORPORATE GOVERNANCE CODE

The UK Corporate Governance Code states in its preface that the code is only a guide in general terms as to principles, structures and processes, and cannot guarantee effective board behaviour.³³⁶ The code deals primarily with processes, but should also deal with personality as that significantly impacts on processes. The code does not contain any provisions aimed at

³³³ See the FRC Report, (note 318) 13.

³³⁴ See the FRC Report, (note 318) 15.

³³⁵ Ibid.

³³⁶ See the UK Corporate Governance Code 2010, p 2.

identifying and managing personality risks. Another salient factor is the “comply or explain” nature of the UK Corporate Governance Code. A crucial effect of this mechanism is that a company is not always obliged to follow the provisions of the code. A company can decide that non-compliance with the code would not negate the principles behind the code provisions. The company is then required to explain the reason for its non-compliance to its shareholders, and if the shareholders are satisfied with this explanation, the code provision is ignored and can be invariably be construed as “non-existent”. There is, therefore, a considerable risk in the fact that the provisions of the code relating to internal control and risk management may not be observed. By way of example, in the UK, the Listing Rules only require that companies disclose whether they have complied with the provisions of the UK Corporate Governance Code, and if not, to disclose the reasons for not doing so.³³⁷

Recently, in a review of corporate governance prepared by Grant Thornton, it was stated that only 50% of all FTSE 350 companies complied with the UK Corporate Governance Code in full, with companies opting for explanations in one or two areas over full compliance and only seven FTSE 350 businesses complying fully with the UK Corporate Governance Code throughout the ten years of the review.³³⁸ The Grant Thornton review indicates a fluctuation in the pattern of compliance over the years, and particularly notes that board structure and composition remains the most common reason for non-compliance with code provisions.³³⁹ The inherent possibility of acceptable non-compliance with the provisions of the code, even a single one, creates an atmosphere of varying standards. The issue of compliance is critical, especially as there are already doubts regarding the effectiveness of corporate governance codes because its flexibility allows a considerable room for the application of discretion and enforcement/monitoring of compliance with governance codes is informally left to company shareholders and market participants³⁴⁰

It has been stated that the efficacy of the “comply or explain” regime is doubtful to the extent that it requires the participation of a sophisticated and discerning set of participants, company directors and company shareholders and that is not realistically the case; and given that the

³³⁷ See Para 9.8.6, UK Listing Rules.

³³⁸ See The Grant Thornton Corporate Governance Review 2011, *A Changing Climate: Fresh Challenges Ahead*, (The Grant Thornton Review) http://www.grant-thornton.co.uk/pdf/Corporate_Governance_Review_2011.pdf, 6 (accessed 15th June 2012).

³³⁹ See The Grant Thornton Review, *ibid* 14.

³⁴⁰ See S. Arcot, V. Bruno & A. Faure-Grimaud, ‘Corporate Governance in the UK: Is the Comply or Explain Approach Working?’ (2010) 30(2) *International Review of Law and Economics* 193-201.

companies in question have a high societal impact, it may be that the “comply or explain” approach is no longer sufficient to ensure compliance.³⁴¹ The fact that there is a level of discretion built into the compliance regime of the code is a good reason why it is important to manage personality risks adequately. This is because that would in turn help manage all the other risks to the extent that appropriate personalities would make better decisions and take better actions in the corporate governance process. Appropriate personalities are also likely to abide and be guided by the spirit of code principles even in cases where enforcement mechanisms for code provisions are ineffective. It is clear from the above analysis that personality risk is not adequately provided for in corporate governance codes and guidance. Again, the voluntary and discretionary nature of corporate governance codes and guidance casts a shadow of doubt on the issue of whether those are the best vehicles to utilize in the development of mechanisms to manage all the aspects of personality risks, considering its significance and impact on the management of all other risks in corporate governance.³⁴²

3.6 UK COMPANIES ACT

UK company law does not provide explicitly for personality risk management mechanisms. UK Companies Act 2006 does not contain specific provisions on internal control and risk management; and has no provisions which deal with the identification and management of personality risks; even though there are several provisions in the Act which can be said to serve as behavioural risk management processes.³⁴³ Directors’ duties aim at specifying the standards of behaviour expected from company directors in the performance of their task. However, the specification of these duties does not in itself ensure compliance with them except to the extent that contravention of the duties may attract certain consequences. If such consequences serve as a deterrent to non-compliance, then behavioural risks as they relate to

³⁴¹ See Richard Anderson & Associates, (note 313) 17. Recently, the Bangladesh Securities and Exchange Commission has proposed amendments to its Corporate Governance Guidelines so that certain recommendations, such as those relating to board composition and size, will cease to operate on a “comply or explain” basis but will become mandatory, see the report at <http://www.corporatelawandgovernance.blogspot.com/2012/02/bangladesh-sec-proposes-amendments-to.html> (accessed 15th June 2012), this development is an indication that there is indeed an increasing awareness that the “comply or explain” approach is not the most effective means of engendering compliance in certain situations.

³⁴² A more detailed discussion on the utility and effectiveness of soft law mechanisms such as corporate governance codes in the management of some aspects of personality risks is undertaken in chapter six.

³⁴³ Examples would include the provisions on Directors’ Duties, Reporting functions, Accounts and Audit functions. See Part 10, Chapters 2-4, Part 15, Chapters 2-10 and Part 16, Chapters 1-3 of the UK Companies Act 2006.

the company directors are managed to that extent. But, if the personalities of company directors are such that the issue of consequences does not serve as deterrence to them, then behavioural risks are not effectively managed by the specification of directors' duties, and personality risks are not specifically managed by the same provisions either. Specifying the duties of directors statutorily can be said to contribute in a way towards identifying personality risks as the provisions aim to articulate standards of behaviour expected of directors, which invariably provides an indication as to the kinds of personalities considered appropriate for directorship roles. This is because behavioural tendencies are expected to emanate from personality dimensions. However, in relation to effectively identifying personality dimensions and managing the associated risks in corporate governance, neither the provisions on directors' duties nor any other company law provisions achieve that aim.

The aim of company law in a contractual theory of corporations as exists in the UK is to provide minimum standards of regulation in support of corporate existence.³⁴⁴ It might be the case that company law provisions are solely aimed at providing the barest minimum standards in relation to issues such as behavioural risks. However, considering the impact of behavioural risks and in turn personality risks on corporate existence, it becomes important to bring the issue under the purview of corporate law if that is a means of ensuring that the issue gets the necessary attention. Corporate law could provide an effective means of dealing with this problem as there are usually prescribed consequences for contravention of the provisions of corporate law. Company directors' disqualification processes also serve as risk management mechanisms to the extent that they prevent persons adjudged as inappropriate from subsequently getting involved in corporate governance. However, the provisions of the Company Directors' Disqualification Act 1986 take effect after the director has committed acts which are deemed inappropriate.³⁴⁵ Therefore, the provisions do not operate in a manner which manages personality and behavioural risks by preventing the commission of inappropriate actions, save in so far as the consequences of disqualification act as a deterrent. Again, the provisions do not address in a direct manner the issue of personality risk management in corporate governance because there is no process which enables the identification of personality dimensions and the particular risks associated with them.

³⁴⁴ See Dine, (note 49) 9.

³⁴⁵ See The Company Directors' Disqualification Act, 1986; see also Hicks, (note 238).

3.7 OTHER REGULATIONS/CORPORATE MECHANISMS

In the UK, the financial sector is regulated by the Financial Services Authority (FSA),³⁴⁶ and it has a personality risk mitigation process in the form of the Approved Persons Regime. This is designed to ensure that persons who hold significant positions in financial companies are “fit and proper” persons according to FSA standards.³⁴⁷ However, even the FSA regime does not explicitly identify personality assessment as a vital issue in determining fitness and propriety.³⁴⁸ The FSA regime does not also establish a clear relationship between personality and behaviour. Recommendations in Basel II and Basel III are also aimed at managing financial and operational risk in banking institutions, but again, there is no explicit articulation of personality risk or processes aimed at mitigating it appropriately.³⁴⁹ The Financial Services Authority Disclosure and Transparency Rules have provisions aimed at risk management. Section 7.1 provides that an issuer must ensure that as a minimum the relevant body must monitor the financial reports, processes and the effectiveness of the issuer’s internal control, internal audit and risk management systems. Section 7.2 provides that an issuer should produce a corporate governance statement which contains a reference to the corporate governance code to which the issuer is subject. There are similar requirements under EU Law.³⁵⁰ These provisions are hinged on the application of the risk management processes embedded in corporate governance codes and guidance, and so do not explicitly create avenues for managing personality risks appropriately.

³⁴⁶ The FSA was established as a regulatory agency under the Financial Services Management Act (FSMA) 2000. Recently, the UK government has announced plans to transfer the prudential operations of the FSA to another authority, the Prudential Regulation Authority (PRA), which would be a division of the Bank of England, by the end of 2012, see the reforms explained in the BBC News <http://www.bbc.co.uk/news/10343900> (accessed 15th June 2012).

³⁴⁷ See The FSA Approved Persons’ Regime at their website <http://www.fsa.gov.uk/Pages/Doing/Regulated/Approved/persons/index.shtml> (accessed 15th June 2012).

³⁴⁸ See the FSA Approval Process at their website <http://www.fsa.gov.uk/Pages/Doing/Regulated/Approved/persons/process/index.shtml> (accessed 15th June 2012); the process is discussed in more detail in chapter seven.

³⁴⁹ Basel II is an international capital framework for banks and Basel III is a comprehensive set of measures developed by the Basel Committee on Banking Supervision to strengthen the regulation, supervision and risk management of the banking sector, see <http://www.bis.org/bcbs/basel3.htm> (accessed 15th June 2012).

³⁵⁰ See EU Council Directive 2006/46/EC of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings [2006] OJ L 224/1.

Enterprise Risk Management (ERM) is another mechanism which is helpful in the management of corporate risks because it is a framework aimed at elevating risk issues to a strategic level and enabling an enterprise wide approach towards risk management.³⁵¹ It goes without saying that ERM is essential and would serve its purpose as long as risk issues are identified and appropriate measures are designed to manage the risks. It is one thing to allocate the responsibility of risk management to specific persons or cadres in an organisation, but it is quite another to identify potential risks and develop structures and procedures for their effective management.³⁵² ERM would be useful in the management of personality risks in corporate governance if these risks have already been identified and definitive processes have been instituted to manage them.

An analysis of the inadequacies in corporate governance mechanisms in identifying and managing personality risks serves to strengthen the argument that behavioural risks have not been managed sufficiently by existing corporate governance mechanisms. For risks to be managed effectively, every element that significantly contributes to the origin and existence of those risks should be identified and managed accordingly. This issue of unmanaged or ineffectively managed behavioural risks becomes significant when attempting to decipher the reasons for corporate failures which appear to be attributable to behavioural issues. If effective corporate risk management is a process which is aimed at managing the risks which could impact on the attainment of corporate goals and objectives, in a manner which ensures that these risks do not truncate the achievement of these goals and objectives, then behavioural risks must be managed effectively if effective overall risk management is to be achieved.

³⁵¹ See COSO, *Enterprise Risk Management-Integrated Framework*, (note 175).

³⁵² See I. Brown, A. Steen & J. Foreman, 'Risk Management in Corporate Governance: A Review and Proposal' (2009) 17(5) *Corporate Governance: An International Review* 546-558 at 550.

3.8 CONCLUSION

This chapter has provided the meaning of risk, indicating its context in the thesis and has also explained what risk management connotes, as well as highlighting the processes involved in effective risk management. The chapter has also discussed risk management in corporate governance, highlighting the origin and development of risk management processes in relation to corporate governance mechanisms in the UK. An evaluation of the extent to which risk management mechanisms in corporate governance provide for the management of behavioural and personality risks was also undertaken. This chapter illustrates that behavioural risks are not managed effectively under corporate governance mechanisms in the UK, because the components which impact on behaviour, particularly personality, and its risk elements has not been effectively identified and managed. More importantly, the chapter has argued that personality risk as a distinct risk issue has not been effectively provided for in corporate governance, and this can undermine the measures established to manage all other corporate risks. Subsequent chapters of the thesis analyse the significant linkage between personality and behaviour, and illustrate that the behaviour of company directors has been a contributory element in corporate failures, a fact which renders personality risk a pertinent issue in corporate governance. An understanding of what risk and risk management entail, as well as a consideration of the fact that personality risk has been unmanaged by corporate governance mechanisms, provides the foundation for an appreciation of the behavioural issues which contributed to the corporate failures discussed in the next chapter.

CHAPTER FOUR

IMPACT OF BEHAVIOURAL RISKS IN CORPORATE GOVERNANCE

4.1 INTRODUCTION

Having discussed the import of risk and risk management, and established that existing corporate governance mechanisms do not provide for the identification and management of personality risk as it relates to behavioural risk, the aim of this chapter is to assess the significance and impact of behavioural risk in corporate governance from a practical perspective. The starting point is an analysis of the manner in which behaviour has been raised as an issue in the investigations and reports following major corporate failures. This is to illustrate how pertinent the issue has become and to highlight the fact that behavioural issues have been viewed as a problem in corporate governance. Then, there is an analysis of the behaviour of company directors in some examples of major corporate failures. The inappropriate decisions and actions undertaken by these directors establish a linkage between behaviour and corporate failures. This chapter also discusses the perceptions of the judiciary and society in relation to the behaviour of company directors as evidenced in some of the court cases following some corporate failures. The last section discusses the issue of behavioural risks in corporate governance, and reiterates the impact of personality on behaviour.

4.2 INVESTIGATIONS AND REPORTS

The practical implications of the issue of behavioural risks in corporate governance can be illustrated by the fact that the behaviour of company directors has been raised as an issue in a lot of corporate failures.³⁵³ The investigations and reports following major corporate failures have re-iterated that behavioural issues were viewed as a contributory problem in the majority of the cases and in some cases led directly to the failure of the companies.³⁵⁴ There has therefore been a heightened emphasis on the behaviour of company directors. Beginning

³⁵³ Examples include the Maxwell Group, Enron, RBS, and Lehman Brothers failures which are discussed in more detail in this chapter.

³⁵⁴ The Walker and Turner Reviews highlighted this issue in relation to the 2008/2009 corporate failures which led to the financial crisis, and reports following corporate failures such as HHH Group and Lehman Brothers also indicate that behavioural issues were a problem in those failures.

with the most recent cases of corporate failures, some of these investigations and reports which are publicly available and relate to major corporate failures are as follows:

4.2.1 The UK Walker Review

In February 2009, in response to the financial crisis and its attendant losses, the UK government commissioned Sir David Walker to undertake a review of corporate governance practices in UK banks and other financial institutions. The final report of the review made recommendations relating to the role and constitution of the board, the role of shareholders, the governance of risk and remuneration amongst other issues.³⁵⁵ Of particular interest are the recommendations made in relation to the behaviour of board members. In the section on psychological and behavioural elements in board performance outlined in Annex 4, Walker states clearly that boards and board behaviour cannot be regulated or managed through organisational structures and controls alone.³⁵⁶ Walker goes on to identify behavioural capabilities and intrinsic traits (personality dimensions) which are required for effective management.³⁵⁷ There is a recommendation that the board of directors should be independently assessed at appointment and annually, and a full psychological assessment should include assessment of behaviour, experience, knowledge, motivation and intellect.³⁵⁸ Walker states that the assessment report should be used not only as a decision making tool for selection of directors but also as a key to avenues of reducing the risks inherent in the board of directors as a group.³⁵⁹ Particularly, Walker indicates that assessments are a means of identifying the current and future potential capability of board directors and corporate leaders.³⁶⁰

It is evident from the recommendations made in Walker that managing the behaviour of company directors is an essential component of effective corporate governance. There is also an acknowledgement of the fact that behaviour cannot be regulated by organisational structures alone,³⁶¹ therefore, the mere presence of established rules, regulations and

³⁵⁵ See the Walker Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations, 26th November 2009, (Walker), (note 10).

³⁵⁶ See Annex 4, Walker, 139.

³⁵⁷ Ibid, 140.

³⁵⁸ Ibid, 141.

³⁵⁹ Ibid.

³⁶⁰ Ibid.

³⁶¹ Ibid, 139.

principles would not suffice to generate the requisite behaviour which engenders effective corporate governance. Walker recommended assessments to be made as regards behaviour, and that would make sense in so far as the assessments target all the aspects that contribute towards behaviour. It is also remarkable that the review highlighted the fact that reports of board assessment are an essential tool for selection purposes and risk management purposes. This in itself is an indication of the perception of Walker that there are behavioural tendencies which would engender effective corporate governance. Hence the recommendation for the use of board behavioural assessment for selection purposes, although ideally, the assessment should cut across several indicators including behavioural elements.

The salient issue to be noted here is that the behaviour of company directors has been highlighted as an area of concern in the light of corporate failures.³⁶² Investigations such as the Walker review would usually involve consultations with the stakeholders in the corporate arena in order to gain their views on the issues which are relevant and worthy of being investigated and reviewed. The fact that behavioural issues were highlighted in the Walker review is a clear indication of how important the subject has become in relation to effective corporate governance and prevention of corporate failures. One major aim of corporate governance is the creation of effective systems and processes for the governance of companies in order to ensure the accomplishment of corporate goals.³⁶³ In Walker, under the section dealing with the context for the review, it is stated as follows:

There were material deficiencies in both financial regulation of individual institutions and in the prudential oversight of the stability of the financial system overall. Substantial public policy initiative is underway domestically in the UK, the US, both nationally and regionally in Europe, and globally, under the Financial Stability Board (FSB), to address these gaps. But there were also material deficiencies in the effectiveness of boards in the well-publicised cases of some financial institutions and, albeit less directly, inadequate capability within major fund managers to protect the interests of those for whom they were acting. Inadequate oversight by the boards and shareholders of the executive management of these BOFI entities and their

³⁶² Walker reviewed behavioural issues in response to the 2008/2009 financial crisis. Other reviews such as the Turner Review and the ICSA Report which will be discussed in this chapter also highlight behavioural issues as a problem in relation to corporate failures.

³⁶³ See the UK Corporate Governance Code 2010, p 1.

*collective failure to understand the new complex products resulted in spiralling enterprise-wide risk.*³⁶⁴

This statement underscores the role played by board behaviour in the crisis and highlights that the external regulatory shortcomings were only one side of the entire story of contributory elements to the failures. Board behaviour is essentially the behaviour of board members. It means that behavioural shortcomings on the part of directors contributed to the crisis. With these levels of conclusions regarding the causes of the recent corporate failures in financial institutions around the world, it is no surprise that Walker made recommendations as to behavioural elements, supposedly with a view to improving the behaviour of directors. The remit of Walker was to consider companies in the financial services sector; nevertheless, the recommendations in relation to behavioural issues are indeed applicable to boards of directors of companies generally, because directors are expected to exert their behaviour in the management of companies and behavioural assessments would be relevant in any case.³⁶⁵

Regardless of the extent to which behavioural issues contributed to the failures, the significant point is that they did. Again, even if there was a way of quantifying exactly how much each of the contributory elements were responsible for the failures, and behavioural issues were found to be less than the prudential regulatory elements,³⁶⁶ the fact would remain that some of the aspects of the corporate failures might have been prevented if there were no behavioural shortcomings. It means, therefore, that the part of the failures attributable to behavioural issues might invariably be non-existent. In the same vein, the negative impact of corporate failure would be expected to have been lessened in similar measure, a situation which would be more favourable for shareholders and the society as a whole. This is because, as highlighted by Walker, the financial crisis was exacerbated by deficiencies in the effectiveness of the boards.³⁶⁷ Had the boards been more effective, some of the issues which

³⁶⁴ See Walker, section 1.10, p 26, BOFI is an acronym for Banks and Other Financial Institutions. References to material deficiencies in the effectiveness of boards, inadequate capability on the part of fund managers and inadequate oversight by boards indicate that there were behavioural issues at the heart of the crisis.

³⁶⁵ Behavioural assessments would indicate whether a director has the appropriate behavioural tendencies which would engender effective corporate governance, as some behavioural traits are considered more conducive for that purpose, see Barrick & Mount, (note 134).

³⁶⁶ Prudential regulations refer to the legal framework for financial operations. They establish rules for activities in the financial sector, and are aimed at ensuring the stability of the financial system. See explanations on the functions of the new UK Prudential Regulation Authority <http://www.fsa.gov.uk/library/communication/pr/2011/043.shtml> (accessed 15th June 2012).

³⁶⁷ See Walker, section 1.10; see also note 10.

led to the financial crisis, and its impact, might have been averted. For instance, in the case that systemic risks are needed to be managed in accordance with specific prudential regulations which were ultimately found to be inadequate, a company might become bankrupt and corporate failure could occur as a result of this.³⁶⁸ However, if the board of directors also failed to report the financial exposures of the company on a timely basis as required of them, it can only worsen a situation which might have been remedied to some extent had a timely report been made. If a timely report is made, the chances are higher that a solution could be adopted which ameliorates the inadequacy of the prudential regulations. Behavioural issues, therefore, have the potential to adversely impact on the overall effectiveness of a corporate governance regime. This is an important reason why there needs to be a focus on reviewing issues relating to behavioural shortcomings on the part of company directors. Effective corporate governance can be engendered by the effective behaviour of the persons involved in corporate governance.

Investigations such as Walker highlight the areas in which change is needed in the light of events that have occurred surrounding corporate failures. Behavioural shortcomings have been identified as an area in which reforms are needed,³⁶⁹ and so rightfully there should be efforts made in response to this identification. Recommendations in Walker regarding requisite behaviour for company directors are certainly a response to the realisation of the necessity to have persons who would behave “appropriately”, in the light of the impact which behaving “inappropriately” has had on companies. The model proposed in this thesis is a similar response, although on a larger scale as it deals with a wider sphere of companies, and utilises different approaches.

4.2.2 The UK Turner Review

The Turner Review which was published in March, 2009 reflected on the financial and regulatory shortcomings which were identified as existing during the recent global financial crisis.³⁷⁰ The Review highlighted the specific details of what went wrong, the developments in the UK as regards financial regulation, fundamental theoretical issues surrounding the failures, and possible solutions to the problems including supervisory improvements for the FSA in the UK. Of particular interest here, and most relevant to the question of behavioural

³⁶⁸ Systemic risks are risks resulting from market or institutional failures and cuts across participants in a system, see S.L. Schwarcz, ‘Systemic Risk’ (2008) 97(1) *The Georgetown Law Journal* 193-249 at 204.

³⁶⁹ See Walker, (note 10) 140 & 141.

³⁷⁰ See The Turner Review: *A Regulatory Response to the Global Banking Crisis*, March 2009, (The Review) (note 9) at http://www.fsa.gov.uk/pubs/other/turner_review.pdf (accessed 15th June 2012).

shortcomings on the part of company directors, is the issue of the ineffectiveness of market discipline. In Section 1.4,³⁷¹ the Review states as follows:

The analysis of the causes of the financial crisis implies the need for major changes in our approach to capital, liquidity, accounting, and institutional coverage, which are addressed in Chapter 2. But the crisis also raises important questions about the intellectual assumptions on which previous regulatory approaches have largely been built. At the core of these assumptions has been the theory of efficient and rational markets. Five propositions with implications for regulatory approach have followed:

- (i) Market prices are good indicators of rationally evaluated economic value.*
- (ii) The development of securitised credit, since based on the creation of new and more liquid markets has improved both allocative efficiency and financial stability.*
- (iii) The risk characteristics of financial markets can be inferred from mathematical analysis, delivering robust quantitative measures of trading risk.*
- (iv) Market discipline can be used as an effective tool in constraining harmful risk taking.*
- (v) Financial innovation can be assumed to be beneficial since market competition would winnow out any innovations which did not deliver value added.*

Each of these assumptions is now subject to extensive challenge on both theoretical and empirical grounds, with potential implications for the appropriate design of regulation and for the role of regulatory authorities.

The Review, therefore, points out that amongst the other issues and challenges posed to efficient market theory, there are implications for the reliance on market discipline rather than

³⁷¹ See the Review, *ibid* 39.

regulatory action in relation to constraining corporate risks.³⁷² It had been assumed that market forces were sufficient to constrain the behaviour of company directors, but the events of recent years have illustrated the inadequacy of market forces in this regard.³⁷³ The Review also states that increased disclosures of corporate activities have been propagated as a key response and in some cases as the single most important response to the crisis.³⁷⁴ However, increased disclosure requirements may not adequately solve the problems which led to the recent financial crisis, and other corporate failures. For instance, in a situation where the market is supposed to rely on information such as the annual reports provided by company directors to determine the relative financial position of a company, and the information provided is false, the utility of the disclosure requirement is undermined. How then can the market for corporate control address any wrongs? Shareholders can only begin to take definitive remedial action if it becomes evident that the information provided is false. If the information provided is of a nature which occasions a spiral of decisions and actions within the market whether positively or negatively, the realisation that it is false may prove too late in emerging.

Again, if company directors are persons accustomed to providing false information, they could still meet the requirements of adequate and increased disclosure. The problem would then be the falsehood of the information disclosed, and it is at this stage that the issue of behavioural deficiencies arise. Increased disclosure would be effective in the sense of triggering the operations of a market in the direction which the information dictates only to the extent that the information provided is valid. So, considering that it is essential for the market to respond to valid information, this means that it is clearly more important to ensure that the information provided is true than it is to ensure that the information is actually provided.³⁷⁵ In cases where there are regulatory requirements or established principles stating that information provided to the market must be true, then it also becomes more essential to ensure that company directors are indeed able to abide by these regulations and principles. It is in keeping with issues such as ensuring that true information is provided to the market that it becomes essential to recruit directors who are capable and accustomed to

³⁷² See the Review, *Ibid* 45.

³⁷³ *Ibid*.

³⁷⁴ *Ibid*.

³⁷⁵ An effective and efficient market has been described as one in which sufficient and valid information is available, see B. Cheffins, *Company Law* (Oxford: Clarendon House 1997).

providing information which is true.³⁷⁶ Any situation other than this is a risk to the corporate governance process, and should rightfully be mitigated if corporate success is desired.³⁷⁷ Market forces may in certain cases influence company directors in pursuing a particular course of action, but it is also possible that market forces will not be able to determine the actual behaviour of these directors in all cases, especially in relation to the everyday governance of companies and the decisions which culminate in the information available to the market. Therefore, the impact of the market for corporate control on the behaviour of directors is diminished to the extent that it relies on adequate and true information provided by the same directors whose actual ability to provide adequate and true information it cannot guarantee.

The Review highlights that evidence from past years illustrates that market forces have actually contributed negatively to failures.³⁷⁸ This holds true particularly in relation to the quest for profit maximisation in which company directors may be keen to take excessive risks in order to increase profits for shareholders.³⁷⁹ In the case that these directors are, for instance, persons who are inclined to disobey established regulations and principles which go against excessive risk taking, the market pressure to maximise profits would invariably aid the propensity and probability on the part of the directors to embark on excessive risk taking.³⁸⁰ If, on the other hand, the directors are persons who are not inclined towards disobeying regulations and principles, there is a decreased risk that market pressures would propel them towards taking excessive risks.³⁸¹ The following example best explains the situation. If excessive risk taking is understandably viewed as morally wrong because it is likely to result in corporate failure, and is viewed as best avoided as a matter of principle, a director who adheres to moral inclinations will more likely than not refrain from excessive risk taking. Again, if excessive risk taking is stated clearly in regulatory provisions as an act which should be avoided, a director who is dutiful would be accustomed to abiding by

³⁷⁶ As will be discussed in chapter five, some personality dimensions are more capable of being dutiful than others.

³⁷⁷ Chapter three highlighted that a risk source is one which has the potential to result in unwanted negative outcomes, see Rowe, (note 164); Rescher, (note 256); Agrawal, (note 165).

³⁷⁸ See the Review, (note 9) 45.

³⁷⁹ The Enron Saga is an example of corporate failure which resulted partly due to excessive risk taking in the bid to increase profits. See Swartz & Watkins, (note 129); see also Deakin & Konzelmann, (note 129).

³⁸⁰ Psychological literature indicates that persons who possess less of the conscientiousness trait are less likely to abide by regulations, see McCrae & Costa, (note 134); see also A.N. Christopher, K.L. Zabel & J.R. Jones, 'Conscientiousness and Work Ethic Ideology: A Facet-Level Analysis' (2008) 28(4) *Journal of Individual Differences* 189-198.

³⁸¹ Ibid.

regulations as a matter of duty, and would more likely than not avoid excessive risk taking. This illustrates the direct impact of behaviour on the actions of company directors and highlights the limits of market forces as it relates to their actions.

The Review also highlights that some of the major decisions taken in companies, RBS in the UK for instance, were clearly risky, and even though institutional investors expressed concerns regarding the decisions, they were neither able nor willing to force any change in direction of the companies.³⁸² This indicates that shareholders are not always in a position to control or influence the decisions of company directors; or willing to do so, a situation which makes it all the more essential to have the most appropriate persons on corporate boards. This way, there is a higher expectation that the decisions they make would be appropriate. The Review concludes as follows “A reasonable conclusion is that market discipline expressed via market prices cannot be expected to play a major role in constraining bank risk taking, and that the primary constraint needs to come from regulation and supervision”.³⁸³ Even though the recent financial crisis emerged in banks and financial institutions and reviews such as the Turner Review have focused on banks, the fundamental issues surrounding these corporate failures and the possible solutions are nevertheless relevant and applicable to other companies, particularly public companies which are traded on the stock exchange, because these companies attract financial commitment from the public and it is essential that they are governed effectively.

Again, the negative effects of the financial crisis have extended to other sectors and society as a whole, and so it becomes imperative to develop solutions which can help prevent similar crises in companies generally. In relation to the recent crisis and the ensuing investigations and reports, specific solutions in terms of developments in financial regulations might appear to be tailored to suit banks and financial institutions, but the behavioural issues highlighted and the recommendations made in relation to them would invariably apply to company directors generally because the same issues could arise in any company. For instance, one of the issues highlighted was to do with abiding by regulations and principles in general.³⁸⁴ The

³⁸² See the Review, (note 9) 46.

³⁸³ See the Review, Ibid 47.

³⁸⁴ An example is the Lehman Brothers failure in which the company directors flouted some provisions of the Sarbanes-Oxley Act. As highlighted in note 380, personality dimensions contribute to the determination of a person's propensity to abide by regulations. This is an issue which is relevant to directors in all companies as corporate governance entails engaging with processes which involve abiding by principles and regulations in codes and corporate law.

issue of ensuring that directors behave appropriately is certainly one which is essential for any kind of company regardless of the sector in which it operates. The Review has highlighted the shortcoming of the market for corporate control, and the analysis above illustrates that market discipline does not influence behaviour in all cases. It is particularly important that the market receives adequate information if it is to exercise effective influence in corporate dealings. This is because shareholders can only take useful and effective actions in relation to a company if they are abreast of the on-goings in the company.³⁸⁵

Part of the aims of the model proposed in this thesis is to provide information to the market regarding the potential behaviour of company directors. The model also provides to the market the information regarding the potential of the corporate information provided by the directors to be true or false. This is because, depending on the judgments made as to the personality and behaviour of directors, the information they provide to the market would also have the potential to be true or false. This information has the potential to influence the responses of the market as regards corporate dealings, and may have an impact on the timeliness and extent of market reactions. For instance, in a case where a company is known to have a board of directors who are dutiful and so are likely to abide by regulations,³⁸⁶ and there is a regulation specifying that all losses incurred by a company must be disclosed to the market within a number of days, when this disclosure is made, the market can be more confident of a number of issues such as that (i) the said loss has actually occurred (ii) it occurred at the time specified (iii) the loss is exactly as disclosed. Increased confidence in the potential accuracy of this information would enable the market to react or respond in a better manner in respect of the information disclosed. The inherent knowledge of the fact that the information is more likely to be true than false will assist the market generally in terms of swifter and more accurate responses as well as influencing the need and cost of verification exercises which might otherwise take place in cases where there is uncertainty about the true state of an affair. Therefore, this is clearly one way in which the model proposed in this thesis can help improve the functioning of the market for corporate control and perhaps help the mechanism influence the actions of company directors more than it ordinarily would.

³⁸⁵ See Cheffins, (note 375).

³⁸⁶ Discussions in chapter five would indicate that there is the possibility of acquiring knowledge as to the potential ability of company directors to be dutiful or otherwise.

4.2.3 The ICSA Report

The Institute of Chartered Secretaries and Administrators (ICSA) in June 2009 prepared an informative report on boardroom behaviour for submission to the Walker Review.³⁸⁷ The report states that an emerging view in the light of the recent crisis is that the system for governance of companies is not inherently broken, but rather that its effectiveness has been undermined by a failure to observe appropriate boardroom behaviours.³⁸⁸ In recognition of this, the ICSA embarked on an analysis of boardroom behaviour and the ensuing report in its executive summary concludes that:

Appropriate boardroom behaviours are an essential component of best practice corporate governance; and that the absence of guidance on appropriate boardroom behaviours represents a structural weakness in the current system;

had that guidance been available and, more importantly, observed, some of the consequences of the current crisis might have been less severe and that, in any case, prevention of a recurrence of the events of the last year is at least partly dependent upon guidance on appropriate boardroom behaviours being incorporated in the Code; and

better articulation of the business case for best practice corporate governance, and more focus on directors' responsibilities and potential liabilities, should incentivise directors to exhibit appropriate boardroom behaviours.

The ICSA Report highlights that its consultation process generated certain observations regarding the characteristics of best practice boardroom behaviour some of which include a clear understanding of the role of the board; appropriate deployment of knowledge, skills, experience and judgment; independent thinking; challenge which is constructive, confident, principled and proportionate.³⁸⁹ The interesting issue here is that the report then goes on to

³⁸⁷ See The ICSA Report (note 10) at <http://www.icsa.org.uk/assets/files/pdfs/consultations/2009/09.04%20ICSA%20Policy%20Report%206.pdf> (accessed 15th June 2012).

³⁸⁸ See the ICSA Report, *Ibid*, at s 1.2, p 3.

³⁸⁹ See the ICSA Report, *Ibid*, at s 2.1, p 4.

state that the extent to which these ideal boardroom behaviours can be achieved is determined by a number of key factors, the first on the list being “the character and personality of the directors and the dynamics of their interactions”.³⁹⁰ This indicates that there is a clear understanding that appropriate behaviours cannot be achieved by persons who do not possess the appropriate character and personality to do so. A director who is not of a personality that is attuned towards abiding by regulations and codes might not take the time required to clearly understand his/her role as a company director, much less abide by the specified role. The ICSA Report states that it considers that in relation to the recent crisis, responses are required at three levels; institutional, organisational and behavioural.³⁹¹ Institutional responses relate to whether corporate governance policies and architecture are fit for purpose.³⁹² Organisational responses relate to company management installing adequate systems and processes.³⁹³ Behavioural responses relate to company directors exhibiting the appropriate behaviours.³⁹⁴

The ICSA Report also states that investigations such as the Walker Review are focusing hugely on institutional and organisational responses in relation to the crisis, but the ICSA report has explored the behaviour of boards beyond the recent financial crisis to the behavioural aspects of boards more generally irrespective of sector and economic circumstances.³⁹⁵ The ICSA Report was subsequently submitted to the Walker Review, so this lends credence to the arguments made in the previous section that reviews undertaken in the aftermath of the financial crisis are nevertheless relevant to companies generally, and are important for the prevention of similar occurrences in the future, irrespective of the sector in which the companies operate. The ICSA Report goes on to recommend that corporate governance codes should be amended to incorporate wording or references relating to appropriate boardroom behaviour amongst other issues.³⁹⁶ The ICSA Report states that the recommendations therein fall short of calling for a more formal requirement for boardroom behaviours to be prescribed or for oversight functions of regulatory agencies to be established.³⁹⁷ It had been highlighted that despite the importance of behavioural considerations, it is remarkable that there is practically no guidance in the corporate

³⁹⁰ See the ICSA Report, *Ibid*, at s 2.2, p 4.

³⁹¹ See the ICSA Report, *Ibid*, at s 3.1.2, p 7.

³⁹² *Ibid*.

³⁹³ *Ibid*.

³⁹⁴ *Ibid*.

³⁹⁵ See the ICSA Report, *Ibid*, at s 3.1.3, p 7.

³⁹⁶ See the ICSA Report, *Ibid*, at s 4.1, p 9.

³⁹⁷ See the ICSA Report, *Ibid*, at s 4.2, p 9.

governance codes on this issue.³⁹⁸ Also, the ICSA Report indicates that it does not consider that formal responses in terms of legislative provisions would be needful and desirable, but that it is possible to formulate guidelines on appropriate behaviour for directors.³⁹⁹ From the foregoing, it can be seen that the ICSA recognises the vital role played by the behaviour of directors in corporate governance. The ICSA Report identifies that behavioural aspects of the board of directors is critical to effective corporate governance and is an area which has been neglected.⁴⁰⁰ The ICSA Report also highlights that behaviour is largely dependent on character and personality, and this would be discussed in greater detail in chapter five. The position of the ICSA as it relates to actions which can be undertaken towards improving the behavioural aspects of the board is a soft law approach in terms of providing guidance in the corporate governance codes.⁴⁰¹

4.2.4 The OECD Report

In June 2009 the OECD Steering Group on Corporate Governance issued a report on the financial crisis.⁴⁰² The OECD Report states that four aspects of corporate governance require urgent attention: remuneration and incentive systems; risk management practices; the performance of boards and the exercise of shareholder rights.⁴⁰³ The OECD Report notes that the negative assessments regarding remuneration policies and risk management continually point back to the board of directors as being both a cause of the problems as well as a potential solution, indeed often the only foreseeable solution in view of the difficulties in specifying direct regulation in a lot of situations.⁴⁰⁴ The financial crisis pointed in a large number of cases to boards of financial companies that were ineffective and certainly not capable of objective and independent judgment as recommended in the OECD Corporate Governance Principles.⁴⁰⁵ The OECD Report notes that approaches such as having board members who are not available at all times and the presence of independent board members

³⁹⁸ See the discussions in chapter three, section 3.5.

³⁹⁹ See the ICSA Report, (note 10), at s 2.3, p 4.

⁴⁰⁰ Ibid.

⁴⁰¹ Ibid, at 3.2.2, p 7.

⁴⁰² See OECD Report *Corporate Governance and the Financial Crisis: Key Findings and Main Messages*, June 2009 (The OECD Report). A financial crisis is defined as a situation in which the supply of money is outpaced by the demand for money. This means that liquidity is quickly evaporated because available money is withdrawn from banks, forcing banks either to sell other investments to make up for the shortfall or collapse, see <http://www.businessdictionary.com/definition/financial-crisis.html> (accessed 15th June 2012).

⁴⁰³ See the OECD Report, Ibid 13.

⁴⁰⁴ See the OECD Report, Ibid 41.

⁴⁰⁵ Ibid.

to act as monitors have proven to be ineffective.⁴⁰⁶ In relation to policy issues and proposals, the OECD Report states that perhaps the most important policy issue is the normative proposal that boards be capable of objective and independent judgment.⁴⁰⁷ The OECD Report further notes that in all of this, the real question is how to promote objective and independent boards and it is stated that one way of so doing is the enforcement of fiduciary duties of directors and the specification of such duties.⁴⁰⁸ The OECD Report also notes, however, that fiduciary duties appear to be a blunt instrument in many jurisdictions, one reason for that being the existence of some form or another of the business judgment rule in many jurisdictions.⁴⁰⁹ It is noted in the OECD Report that the “fit and proper person” test applied in the financial industry is usually in relation to basic board behaviour of propriety and honesty. The test has thus encompassed issues of fraud and history of bankruptcy, but, in the light of the crisis, such tests should be extended to technical and professional competence, especially skills needed for corporate governance generally.⁴¹⁰ In conclusion, the OECD Report states:

*In sum, it appears to be difficult to find a “silver bullet” in the form of laws and regulations to improve board behaviour and performance. It is simply not possible to regulate for board competence and objectivity. Improved enforcement of fiduciary duties and other forms of legal liability might help although it is a blunt instrument. Some other options might be available in banking but these do assume that the authorities possess important information and an ability to act. At the end of the day, it is hard to escape the conclusion that the appointment and recall of board members might be seriously flawed, raising questions about shareholder behaviour.*⁴¹¹

It is interesting to note that the OECD Report emphasises the ineffectiveness of fiduciary duties and other forms of legal liability. This is true because in the face of mechanisms such as this which are already in existence, the financial crisis still

⁴⁰⁶ See the OECD Report, *ibid* 42.

⁴⁰⁷ See the OECD Report, *ibid* 44.

⁴⁰⁸ See the OECD Report, *ibid* 44 & 45.

⁴⁰⁹ See the OECD Report, *ibid* 45.

⁴¹⁰ *Ibid*.

⁴¹¹ See the OECD Report, *ibid* 46.

occurred and board behaviour is stated as a fundamental cause.⁴¹² This situation certainly strengthens the argument for a focus on the behaviour of board members, as this is a factor which contributes to board effectiveness.⁴¹³ If directors are not appropriate persons who are capable of exercising objective and independent judgment for instance, the presence of principles and regulations may not create the effectiveness required in corporate governance. It is understandable to see the OECD Report stating emphatically that it is simply not possible to regulate for board competence. In relation to regulating behaviour, this assertion would assumedly be based on reasons such as the freedom of shareholders to appoint directors of their choice and the uncertainty as to what contributes to overall board behaviour and performance. It could also include the fact that board members are not usually assessed in order to ascertain their behavioural tendencies, the lack of adequate knowledge regarding the relationship between personality and competence in corporate governance, and most importantly, the fact that regulation is generally not an immediate option in corporate governance due to the preference for self-regulation. However, the pertinent reason why investigations are undertaken when crises like these occur is so that the reasons for their occurrence are identified, and also to develop means of preventing similar occurrences in the future. This presupposes that in-depth thought must be given to all possible avenues of preventing the situations which led to the crisis, including taking on approaches that have never been tried before, as long as there are strong indications to support the possibility that the approach is a solution.

The perspective to adopt in the light of the conclusions reached in the OECD Report is to evaluate the conditions which create the desired board behaviour and performance, and then create a corporate atmosphere which fosters those conditions. For instance, there should be an analysis of the factors which result in board competence and objectivity, and then efforts should be made to engender those factors in company boards. Promoting board objectivity and independence should simply be an exercise in identifying the factors which contribute towards the

⁴¹² For instance, in the Lehman Brothers failure, the consequences for contravening the provisions of the Sarbanes-Oxley Act did not deter the company directors from doing so. Again, in the RBS failure, inappropriate decisions were taken despite the existence of s 172 of the Companies Act 2006 which specifies that directors must act in the best interests of the company, amongst other issues.

⁴¹³ This was stated in the ICSA Report, (note 10), at s 1.2, p 3.

achievement of these ends, and putting those factors in place. As behaviour is one of the factors which impacts on effectiveness, it is pertinent to explore the factors which impact on behaviour. Then the next step is to decipher which aspects of behaviour contribute to appropriateness, since appropriate behaviour impacts more positively on effectiveness. Efforts should then be made to ensure that persons who are involved in corporate governance are capable of appropriate behaviour. It is equally important to ensure that the approaches adopted in the pursuit of these objectives are such that they can deliver the desired ends. Therefore, changes in policy direction and previously accepted paradigms are consequential developments which should be acceptable in cases such as this in which problems are identified and solutions are desired. So, contrary to the indications in the conclusion of the OECD Report, it is actually possible to regulate for board competence and objectivity because any regulation which contributes to improvement in these directions is in fact a regulation for the purpose. For instance, regulation which is aimed at ensuring that company directors are persons who are capable of objective and independent thinking is certainly regulation in this regard, and albeit a challenging prospect, it is nevertheless a possibility. Indeed, the OECD Report states clearly that the financial crisis represents a challenge for corporate governance policy, one which is akin to the challenges that followed the collapse of Enron and the Asian financial crisis of 1997.⁴¹⁴ The OECD Report concludes that the process for the appointment of directors is flawed, and that shareholders alone are not able to make the best decisions on this issue. Particularly in relation to public listed companies, regulation in this area should be inevitable if that is a means of creating an effective solution to the behavioural problems commonly identified by the reports on the financial crisis.

There are a number of issues which determine a director's ability to contribute to effective corporate governance, and behaviour is one of them.⁴¹⁵ If more effective and sustainable systems of corporate governance are desired, a good approach is to

⁴¹⁴ See the OECD Report, Ibid 12.

⁴¹⁵ This is evident from the reports discussed here which indicate that behavioural issues can undermine effectiveness, and also highlight the importance of professional competence and skills. The UK Corporate Governance Code provides in Provision B.2.2 that the nominations committee shall evaluate the balance of skill, knowledge and experience required by the board in its pursuit of recruiting directors, a clear indication that such issues are necessary for corporate governance.

provide a systematic improvement in effectiveness in all the areas which contribute to overall corporate governance. A situation in which some areas become the focus of attention and development whilst others are ignored cannot augur well for the entire process of corporate governance in the long run. The issue of behavioural deficiencies has been highlighted but efforts to create improvement in this area have not included a detailed analysis of all the factors that contribute to behaviour, of which personality is a key one.⁴¹⁶ Regulation should be applied in cases where it has been identified as essential, and soft law approaches can be utilised in cases where they would prove more effective.⁴¹⁷

The OECD Report notes that strengthening the enforcement of fiduciary duties of directors or their statutory duties as the case may be is one way of bringing improvement to the behaviour of directors.⁴¹⁸ This might indeed have an effect on the behaviour of directors in terms of their being deterred as a result of consequences. However, as has been argued previously, statutory duties which impose behavioural expectations on directors are not likely to change the behaviour of a director who is not naturally attuned to behaving in the manner proposed by the statute.⁴¹⁹ For instance, section 172 of the UK Companies Act 2006 provides that directors should promote the interests of the company whilst taking cognisance of certain constituencies. But, the real and more important issue actually lies in the capability of the director in question to abide by the provisions of the statute. Resorting to punishment for contravention of a statutory provision is an option, but, it is better to develop approaches which engender behavioural conformity in the first instance, than depend on the efficacy of enforcement mechanisms which operate *ex post*. This is because if the enforcement mechanisms do not act as deterrence, then the statutory provision stands a chance of being contravened. Enforcement mechanisms are put in place to ensure that compliance is secured, and so if there is a

⁴¹⁶ For instance the Walker Review highlighted behavioural issues but the subsequent review of the UK Corporate Governance Code did not include significant changes in that direction, and certainly has no provisions in relation to directors' personality. Chapter five discusses personality and behaviour in more detail.

⁴¹⁷ The utility of adopting hard law and soft law approaches in different situations is discussed in more detail in chapters six and seven in relation to the hybrid model proposed.

⁴¹⁸ See the OECD Report, (note 402) 44 & 45.

⁴¹⁹ See Keay, (note 245); see also Fisher, (note 245); see the BIS Review, (note 244); see also N. Okoye, 'The BIS Review and Section 172 of The Companies Act 2006: What Manner of Clarity is Needed?' (2012) 33(1) *The Company Lawyer* 16-17.

chance that these mechanisms might not secure compliance, then other approaches which might do so should be explored. In a lot of cases, the recent financial crisis being an example, the greater harm would already have occurred before the enforcement mechanisms of laws enacted to safeguard their occurrence actually sets in. Although there is the potential of punishment acting as deterrent, cases have also shown how ineffective this approach can be, because existing regulations did not prevent directors from inappropriate behaviour in the recent crisis.⁴²⁰

4.2.5 The EU Green Paper

The European Commission in April 2011 issued a Green Paper on the corporate governance framework for the EU region.⁴²¹ The Green Paper states that “corporate governance is one means to curb harmful short-termism and excessive risk-taking”.⁴²² The purpose of the Green Paper was essentially to assess the effectiveness of the current corporate governance framework for European companies in the light of the EU agenda.⁴²³ The Green Paper addresses three key areas of corporate governance: the board of directors, the shareholders and the application of the “comply or explain” approach.⁴²⁴ There is a clear acknowledgement of the vital role played by the board of directors in the development of sustainable and responsible companies and the paper discusses various aspects of the company board, but of particular relevance is the fact that the Green Paper poses a question seeking to ascertain whether recruitment policies of companies should be more specific in relation to the profile of directors.⁴²⁵ The

⁴²⁰ See the recent Lehman Brothers example where directors clearly flouted the Sarbanes-Oxley regulations. Also, in the Enron scandal, the directors and executives flouted established regulations.

⁴²¹ See the EU website, *Green Paper on Corporate Governance Framework for the EU Region* (The Green Paper) http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf (accessed 15th June 2012).

⁴²² See the Green Paper, *ibid* 2.

⁴²³ The EU Green Paper states that corporate governance and corporate social responsibility are key elements in building people’s trust in the single market, and they also contribute to the competitiveness of European businesses because well run sustainable companies are best placed to contribute to the ambitious growth targets set by “Agenda 2020”. See the details of the agenda at http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/115346.pdf (accessed 15th June 2012).

⁴²⁴ See the Green Paper, (note 421) 3.

⁴²⁵ See the Green Paper, *ibid* 7.

Green Paper also seeks to ascertain how best these initiatives could be achieved and the level of governance at which these interventions may be made.⁴²⁶

Although the Green Paper does not specifically refer to personality profiling, it does state that directors should ideally be selected based on a broad range of criteria which includes the personal qualities of the candidate.⁴²⁷ The attention being given to the issue of personality at the EU level is a reflection of the fact that the issue has not been adequately addressed in the past, and there is a clear understanding of its importance in corporate governance. In addition to considerations regarding the level of governance at which policy interventions in relation to recruitment of directors are to be made, it is equally important to utilise effective regulatory instruments. There is a necessity to ensure that the approach adopted towards tackling this issue is effective and sustainable. The responses to the questions posed in the Green Paper in relation to recruitment policies indicate that the respondents were almost equally divided between those who favoured specific measures and those opposing them.⁴²⁸ Some of those favouring more specific recruitment policies were against regulation at EU level, indicating that responses at the national level or at the level of the companies, through the nominations committee, was more appropriate.⁴²⁹ The respondents who were against specific recruitment policies considered that there was no need for action in this regard and indicated that one size should not fit all in this case.⁴³⁰ It is agreed that one size might not fit all companies in terms of specific recruitment policies; however, considering that the behaviour of directors was a contributory factor to the financial crisis and other corporate failures, and the fact that personal qualities influence behaviour, recruitment policies which take cognisance of personality dimensions are clearly needed.

Responses to the questions in the Green Paper were bound to generate varying approaches and different solutions to the problems presented, possibly dependent on the peculiar perspectives of a respondent, but one salient factor is that where the

⁴²⁶ Ibid.

⁴²⁷ See the Green Paper, Ibid 5.

⁴²⁸ See the responses at http://ec.europa.eu/internal_market/company/docs/modern/20111115-feedback-statement_en.pdf, p 7 (accessed 15th June 2012).

⁴²⁹ Ibid.

⁴³⁰ Ibid.

problem is viewed as real, whatever approach is proposed as regards dealing with the issue of personality is one which fundamentally acknowledges the place of personality in corporate governance. The place of personality in relation to behavioural risks in corporate governance processes and the need to develop a mechanism which mitigates these risks in the bid to help enhance effective corporate governance in companies and prevent corporate failures is the crux of this thesis. It is evident in any case that the European Commission sets out in the Green Paper to assess the existing corporate governance framework with a bid to developing improvements to the framework, therefore, it is noteworthy that personality is indeed one of the highlighted areas. Instituting recruitment policies which take cognisance of the personality dimensions of directors is one way of ensuring that appropriate persons are selected as directors, and at the least, it would provide information regarding the personality of directors for risk management purposes even in cases where inappropriate persons are selected.

4.3 THE BEHAVIOUR OF COMPANY DIRECTORS IN CORPORATE FAILURES

The model suggested in this thesis is particularly directed towards company directors. Directors are the persons at the helm of affairs in a company and all other corporate officers are expected to act in accordance with instructions emanating from company directors.⁴³¹ Therefore, if personality risks are dealt with effectively at the level of company directors, then there are higher chances of creating effective corporate governance. In an ideal situation, it would actually be most effective to evaluate every corporate officer in the same manner as company directors so as to ensure that their personalities are appropriate for corporate governance. But, other corporate officers essentially execute the instructions and follow the policies issued by company directors. So, as long as these persons execute the orders as given, it is

⁴³¹ In the UK for instance, see s 20, UK Companies Act 2006; see also Art 3 of the Model Articles for private limited companies and public companies which states that subject to the articles of association, the company directors are responsible for the management of the company's business. Art 5 of the Model Articles grants the directors the power to delegate their duties to the management executive if they so desire, but this does not subjugate the primary responsibility of management which inherently resides in the company directors themselves.

more imperative to start by ensuring that these instructions are in accordance with the corporate objectives and in line with established rules and norms.

The examples of corporate failures examined below show that the actions of company directors contributed to these failures, and even in cases where the corporate officers were not directors, the actions they undertook might as well have been undertaken by company directors. This is because the directors had an overall duty to ensure the effective management of the companies culminating in a situation where other corporate officers should act only based on instructions from the directors or take decisions that are only within the lines approved by the directors. Therefore, these actions are still relevant in drawing a linkage between the behaviour of directors and situations contributing towards corporate failures. The specific actions and decisions undertaken by company directors in the following examples indicated to a large extent their behavioural tendencies and the risks contributed to the corporate governance process as a result of their behaviour.⁴³² The relationship between inappropriate behaviour and corporate governance is a clearly negative one to the extent that there is evidence in these examples to show that persons who behave inappropriately would invariably be ineffective at corporate governance. It is much the same as the relationship between effective corporate governance and corporate success. As much as it may not be absolutely proven that effective corporate governance can guarantee corporate success, it is nevertheless proven that ineffective corporate governance would invariably lead to corporate failure.⁴³³

Even if there is a perception that creating effective corporate governance does not generate significant increases in terms of profit for companies, the more important issue is whether effective corporate governance reduces the risks of potentially huge

⁴³² The behaviour of these directors constituted risks to the corporate governance process as it was a contributory factor to the corporate failures. A recent example of how the issue of inappropriate behavioural tendencies can affect the successful management of organisations can be seen in the Scottish Football Association's verdict concerning the former owner and chairman of Rangers Football Club to the effect that he was unfit to hold that position because his behaviour had brought the game into disrepute. The problems at the football club are still on-going and being investigated, but there is no doubt that these issues have resulted in negative impacts on the club, its players and their fans.

⁴³³ See J. Solomon, *Corporate Governance and Accountability* (3rd ed., Chichester: Wiley 2010) 72 where the author states even though there is no conclusive evidence that corporate governance leads to better financial performance, there is an indisputable evidence of a negative relationship to the extent that weak corporate governance has been shown to lead to financial losses.

losses to shareholders, and it has been argued that there is a significant statistical relationship between ineffective corporate governance and poor corporate financial performance leading to the reasonable conclusion that corporate governance mechanisms should lessen the risk of corporate failure and financial distress.⁴³⁴ Therefore, in the case that there is evidence, as will be seen in this thesis, to indicate that certain behavioural tendencies are more likely to result in ineffective corporate governance and increase the risks of corporate failure, it is pertinent to understand what contributes to these behavioural tendencies and take appropriate steps to mitigate these risks in the case that effective corporate governance and prevention of corporate failures is desired.

4.3.1 THE MAXWELL GROUP

The proprietor of the Maxwell Group Plc, Mr Robert Maxwell, disappeared at sea from his yacht in 1991 after the realisation that his financial empire was in ruins, a situation caused by his misappropriation of company funds through actions ranging from pledging assets as security for loans and subsequently selling the assets; diverting shares and cash between his companies; manipulating the share prices of his companies and generally converting company funds to his private use; to cases of misrepresentations as to the financial positions of the companies.⁴³⁵ Much earlier, in a transaction with an American company (Leasco) which was bidding to take over one of Maxwell's companies, issues arose as to the authenticity of the financial position of the company as projected by Mr Maxwell. The dispute which arose resulted in the Takeover Panel commissioning a full Board of Trade inquiry into the fiasco and two inspectors were appointed, as well as an independent audit carried out by Price Waterhouse, the result of which was the declaration that the reported profits of the Maxwell company in question (Pergamon) for 1968 had been overstated from £140,000 to £2,100,000. More importantly however was the report issued by the inspectors and published in July 1971 in which the following statement was written:

⁴³⁴ See Solomon, *Ibid* 70-72.

⁴³⁵ See N. Davies, *The Unknown Maxwell* (London: Pan Books 1993) 332; see also T. Smith, *Accounting for Growth* (London: Century Business 1992) 10-12.

*We are also convinced that Mr Maxwell regarded his stewardship duties fulfilled by showing the maximum profits which any transaction could be devised to show. Furthermore, in reporting to shareholders and investors he had a reckless and unjustified optimism which enabled him on some occasions to disregard unpalatable facts and on others to state what he must have known to be untrue...We regret having to conclude that, notwithstanding Mr Maxwell's acknowledged abilities and energy, he is not in our opinion a person who can be relied on to exercise proper stewardship of a publicly quoted company.*⁴³⁶

In two subsequent reports by inspectors in 1972/73, Mr Maxwell's business methods were criticized.⁴³⁷ Maxwell was nevertheless still allowed to hold executive and managerial position after the discovery of these flaws in his personality; only for a greater manifestation of his personality traits to occur 20 odd years later in 1991, with far greater implications.⁴³⁸ The Department of Trade and Industry (DTI) report on the Maxwell Group collapse stated that it was clear to many people who dealt with Mr Maxwell that "he was a bully and a domineering personality, but could be charming on occasions".⁴³⁹ It becomes easy to relate his actions in the running of his companies to his personality, as Mr Maxwell clearly dominated the management of his companies.⁴⁴⁰ The risks associated with inappropriate personalities are a fundamental reason why it is essential to have appropriate kinds of personalities in company management.⁴⁴¹ The net result of the Maxwell scandal was the complete collapse of the Maxwell Group, with huge consequences in terms of job and pension losses, capital destruction and reduced confidence in business activities. The DTI report states categorically that "As a result of the collapse, many pensioners suffered anxiety and loss, and the employees of Mr Robert Maxwell's companies suffered uncertainty and redundancy..."⁴⁴² One of the far reaching effects of the failure was the fact that Kevin Maxwell, son of the proprietor, was reputed to be Britain's

⁴³⁶ See Bower, (note 126) 286-287.

⁴³⁷ See the summary of the DTI Report published by Mirror Group Newspapers Plc in London, 2001, p 3, available at <http://www.pixunlimited.co.uk/Media/pdf/mirrorgroup.pdf> (accessed 15th June 2012).

⁴³⁸ See Wearing, (note 2) 32-34.

⁴³⁹ See the DTI Report, 2001, p 319; see also Wearing, *ibid* 35.

⁴⁴⁰ See the summary of the DTI Report, (note 437) 5; see also Bower, (note 126) 346.

⁴⁴¹ See The FSA Press Release, 'Financial Regulation: Learning the Lessons of Maxwell' (2001) at <http://www.fsa.gov.uk/Pages/Library/Communication/PR/2001/143.shtml> (accessed 15th June 2012).

⁴⁴² See the summary of the DTI Report, (note 437) 14.

biggest bankrupt in 1992 after admitting debts of about four hundred (400) million pounds.⁴⁴³

From the foregoing, it is evident that Mr Maxwell exhibited inappropriate behavioural tendencies in respect of corporate governance. By way of example, the pertinent action of inflating his company profits is one which indicates that he was not a person who acted with integrity, neither was he one to abide by corporate financial regulations which required the presentation of a true and fair view of a company's financial position. Also, the fact that Mr Maxwell intended to employ deceit in a bid to secure the take-over of his company by Leasco is an action which portrays him as someone who is capable of dishonesty. Again, the misappropriation and abuse of his employees' pension funds and the appropriation of corporate funds for his private use are actions which indicate that he was a person who lacked the traits of self-discipline and dutifulness. The DTI report states in conclusion as follows:

*The most important lesson from all the [Maxwell] events is that high ethical and professional standards must always be put before commercial advantage. The reputation of the financial markets depends on it.*⁴⁴⁴

The above conclusion suggests the relevance of personality and behavioural issues in corporate governance because essentially, it would take appropriate behavioural tendencies to exhibit high ethical and professional standards in the governance of companies. The Maxwell case also raises an important issue that is central to corporate governance, that of ethics. No amount of corporate governance checks and balances, codes of practice or even regulation can change a person's character and personality.⁴⁴⁵ If Mr Maxwell had been a person who exhibited appropriate behavioural tendencies, or there were mechanisms in place to mitigate the risks which accrued to the governance process as a result of his inappropriate behavioural

⁴⁴³ See *The Financial Times*, 27th August 2004.

⁴⁴⁴ See the summary of the DTI Report, (note 437) 15.

⁴⁴⁵ See Solomon, (note 433) 48.

tendencies, the chances exist that the collapse of the Maxwell Group might have been prevented or its consequences reduced at the least.

4.3.2 BCCI

Bank of Credit and Commerce International Plc (BCCI), a large international bank with branches in over 70 countries, collapsed in July 1991.⁴⁴⁶ The bank had been founded by Agha Hasan Abedi in 1972, and was essentially managed until its failure by himself and Swaleh Naqvi, an early associate.⁴⁴⁷ The origin of the collapse was traced to a situation in which the executives started falsifying BCCI's accounts in order to hide the financial difficulty that was occurring within one of its major customers, the Gulf Group. This eventually led to a liquidity problem in the bank. Also, there were allegations that BCCI became involved in money laundering activities on behalf of drug dealers in Columbia, resulting in the arrest of some officials of the bank in Florida, United States in October 1988.⁴⁴⁸ The United Kingdom Prime Minister at the time commissioned Lord Justice Bingham to report on the events that led to the collapse and the report published in 1992 indicted the auditors, Price Waterhouse for creating an avenue for conflict of interest by acting as both auditors and consultants to BCCI. The Bingham Report also criticised the Bank of England, for lacking in its supervisory role.⁴⁴⁹

The blame on the Bank of England was quite valid as it should have been obvious to anyone much earlier than 1991, when the Bank of England chose to wind down operations at the bank, that there were issues at BCCI which needed investigation, especially with the arrest of the BCCI officials in the United States in 1988. Again, the behaviour of the company directors was in issue as was evident from their actions. For example, the UK Companies Act 1985 specified clearly in its section 221 (1) that every company shall keep accounting records which disclose with reasonable accuracy the financial position of the company at any given time. The directors at BCCI disobeyed this requirement. Had the company accounts not been

⁴⁴⁶ See Wearing, (note 2) 54.

⁴⁴⁷ See Wearing, *Ibid* 55-56.

⁴⁴⁸ See Wearing, *Ibid* 57-58.

⁴⁴⁹ See Bingham, The Right Honourable Lord Justice, *Inquiry into the Supervision of the Bank of Credit and Commerce International* (note 127).

falsified, the financial distress in the company might have been discovered earlier. Also, it is clearly against established rules for a company to engage in money laundering,⁴⁵⁰ and so the directors at BCCI who indulged in and approved this activity can be described as persons who lack integrity. The collapse of BCCI created financial losses for a large number of individuals (the bank had over one million depositors), employees (BCCI was reputed to have had about 14,000 worldwide), companies (a lot of businesses banked with BCCI), local authorities (one of which was a small council in Scotland which lost \$45 million), and countries (BCCI had branches scattered around numerous countries).⁴⁵¹

4.3.3 HIH

In Australia, the HIH Insurance Group Plc collapsed in March 2001, resulting in crystallised losses amounting to approximately \$5.3 Billion.⁴⁵² An analysis of the Royal Commission Report after the crisis portrays a company which was totally mismanaged by a CEO (Raymond Williams) who was particularly dominant and could not be rivalled in terms of authority or influence.⁴⁵³ This, amongst other factors rendered the rest of the company board including Geoffrey Cohen, its chairman, practically ineffective. The HIH directors involved the company in high risk practices in an extremely competitive market and the company ended up under-reserving its claims, a fact which eventually led to its collapse.⁴⁵⁴ The company directors at HIH failed to see, remedy and report what appeared to be obvious problems, and in fact management concealed the true state of the group's financial position.⁴⁵⁵ The failure of HIH was the result of attempts to conceal the difficulties caused by over-priced acquisitions.⁴⁵⁶ The following are some excerpts and highlights from the Royal Commission Report which illustrate the behavioural issues that contributed to the collapse of HIH:

⁴⁵⁰ Some officers of the bank were arrested for the offence of money laundering, see Wearing, (note 2) 57-58.

⁴⁵¹ See Wearing, (note 2) 63.

⁴⁵² See the HIH Royal Commission Report 2003 at www.hihroyalcom.gov.au/finalreport/index.htm (accessed 15th June 2012).

⁴⁵³ Ibid.

⁴⁵⁴ See the HIH Report, Ibid; see also Hill, (note 119) 367.

⁴⁵⁵ Ibid.

⁴⁵⁶ Ibid.

The last years of HIH were marked by poor leadership and inept management, an attitude of indifference and deliberate disregard of the company's problems.

The officers of the company who were responsible for its stewardship ignored warning signs at their own, the group and the public's peril.

The primary reason for the failure was "under-reserving", but why did the company under-reserve?, Because it was mismanaged.

The factors which contributed to the mismanagement of the group were:

- i) Lack of attention to detail*
- ii) Lack of accountability for performance*
- iii) Lack of integrity in the company's internal processes and systems*
- iv) Bad business decisions which were poorly conceived and even more poorly executed*

A cause for serious concern was the group's corporate culture which connotes the personality, sometimes overt but often unstated which guides the decision making process at all levels of an organisation. In HIH, the corporate culture was inimical to sound management practices and it resulted in decision making that fell short of the required standards.

The problematic aspects of the corporate culture at HIH which led directly to poor decision making can be summarised as a blind faith in a leadership that was ill-equipped for the task. There was insufficient ability and independence of mind in the organisation to see what had to be done, stopped or avoided.

Even though management is in a better position to propose strategy, the board of directors has the responsibility to understand, test and endorse this strategy. This is what the HIH board failed to do.

The CEO was dominant, not a problem in itself, but in order to have an effective management team, other officers needed to have their voices heard.

The presence of written guidelines does not guarantee that there will be no departures and if there are no systems of checks and balances in operation, or if they fail, then losses will occur.

Guidelines were flouted in HIH. For example, the procedures prohibiting “fronting” without management approval were flouted, as well as the company’s investments guidelines as many investments exceeded board approval guidelines and limits. This was highlighted in a letter to the CEO in August 2000 by the APRA following a credit risk management visit at HIH.

Concerns about governance were raised by two of the directors in 1999 but the issues were never considered at a full board meeting. The CEO was not interested in pursuing the issues and they soon blew over.

Head, one of the directors who raised the governance concerns eventually resigned in 1999. The other director, Gardner, concluded his concerns will not be acted upon and did not bother to raise them again.

The final decisions on whether a company’s accounts are accurately reflecting the financial state of the company rests with the company directors and not with the management or auditors.

There should be an underpinning of morality and ethical standards in all decision making processes, far and above rules, obligations, regulations, codes etc. Prescriptive dictates should be adhered to no doubt, but the more important issue is the rightness of a decision.

An examination of these excerpts from the HIH Report as highlighted above evidences the numerous behavioural issues which were at the forefront of the problems in the company. For example, the company chairman clearly did not abide by his duties to the extent that he ignored management excesses and failed to investigate governance issues even when two directors raised them. Had the chairman and all the members of the board been persons who were full of integrity

and abreast of their role and responsibility on the board, a number of management decisions which contributed to the failure would have been adequately challenged and perhaps some of the mishaps would have been averted. The CEO aided the board in the approval of falsified accounts, the report clearly indicating that the board practically adopted the decisions of management and not the other way round. Had the CEO been a person with appropriate behavioural tendencies, the corporate collapse of HIH may have been prevented because the decisions which led to the failure may have been prevented.

Even in the situation that the CEO was an individual with a dominant personality as was the case in HIH, if all the other board members were persons who behaved appropriately, the chances are higher that they would question the decisions of the CEO and if their voices were not heard, they could all resign. If all the board members resigned, the governance issues would have been brought to the attention of the shareholders, the regulatory bodies and the wider public. Then, the governance issues would have been addressed sooner than later. The actions of Mr Head in resigning from HIH in the face of not obtaining answers to his governance questions was clearly a good decision and it can be assumed from his actions that he was a person of integrity who did not want to be part and parcel of questionable and ineffective corporate governance. The impact of the HIH collapse was far reaching, causing problems for individuals and the community as well as serious consequences for the public. Examples of these include the fact that a number of permanently disabled persons no longer had access to their insurance funds, numerous retirees were left without retirement funds and various home owners who took out compulsory warranty insurance were left practically uninsured.⁴⁵⁷

4.3.4 ENRON

The Enron collapse has generated a word which links the failure to broader corporate governance issues as follows: “[Enronitis is] A malfunction of corporate governance in which top managers become extraordinarily wealthy while misleading shareholders, creditors, employees and the general public about the company’s

⁴⁵⁷ See Andrew, Cooper & Islam, (note 141).

prospects and practices, eventually resulting in share price collapse, loss of jobs, and in extreme cases, the corporation's bankruptcy....." ⁴⁵⁸ Professor Greenwood may have been attempting a linguistic exercise in this instance, but his description of the Enron syndrome aptly captures the reality of what actually took place. During the 1990s, Enron grew from a small domestic Texan energy company to become one of the largest United States corporations, taking advantage of deregulation and globalisation to create opportunities which translated to profit and growth. ⁴⁵⁹ It was a company run by "apparently" respectable persons with huge political connections and had been ranked for several years in a row as *Fortune* magazine's most innovative company. ⁴⁶⁰ Suddenly, it collapsed, due to disclosures of non-existent transactions which were placed as off balance-sheet items and consequently, estimated incomes which would never materialise.

The company filed for bankruptcy on 2nd December 2001 resulting in the loss of thousands of jobs and over \$1 billion of its employees' retirement savings. ⁴⁶¹ An examination of the actions of key Enron executives supports the assertion that company agents bring their personalities to bear on corporate decisions which ultimately may or may not contribute to the success of the company. In a paper by Sherron Watkins, a former vice president of Enron and the "whistle blower" at the company just before its collapse, there is an account of how Kenneth Lay, a Chief Executive Officer (CEO) at Enron would verbally preach the company's core values of respect, integrity, communication and excellence (RICE); and yet would not live up to its tenets by getting involved in situations such as compelling Enron employees to patronise his sister's travel agency constantly even when that agency did not provide affordable and excellent service. ⁴⁶² Mr Lay's actions suggest that he was a person who did not abide firmly by the values of integrity and professionalism. Jeffrey Skilling was CEO of Enron between February and August 2001. He was described as someone who infused a new business image into the company, one that placed emphasis on generating profit, regardless of the cost. This

⁴⁵⁸ See Greenwood, (note 141) 774.

⁴⁵⁹ See Unerman & O'Dwyer, (note 141) 980.

⁴⁶⁰ See McLean & Elkind, (note 129).

⁴⁶¹ See Swartz & Watkins, (note 129); see also Deakin & Konzelmann, (note 129).

⁴⁶² See the address of former Enron vice president Sherron Watkins at the Academy of Management on 3rd August 2003, available in the *Academy of Management Executive*, Vol 17(4), p 123.

resulted in the company recruiting only the brightest traders and rewarding achievement with outrageous salaries and bonuses; with Mr Skilling instituting a Performance Review Committee which became known as the harshest employee-ranking system in the United States.⁴⁶³ The “supposed” core values of the company were relegated to the background and replaced with a relentless drive towards profit making, a situation which could result in a negation of professionalism in the long run, as eventually occurred at Enron.

The Chief Financial Officer (CFO) of Enron, Andrew Fastow, actually set up three partnerships that engaged in business transactions with Enron and formed part of the reason for the losses that the company disclosed eventually.⁴⁶⁴ It is difficult to think that the company directors at Enron could not have known the level of conflict of interest that would naturally result in a situation in which its CFO is consummating business transactions between a company he works for and a partnership he owns. As it turned out, those partnerships were primarily set up to facilitate Enron’s financial dealings, and this illustrates how directors can get tangled up in a web of self-dealing.⁴⁶⁵ Enron directors appeared to allow Mr Fastow run those partnerships because it was benefitting their interests and enhancing their profit maximisation drive, regardless of the fact that it was bound to create issues of conflict of interest at the expense of shareholders. At one stage, Andrew Fastow was also lobbying the rating agencies to provide Enron with positive credit ratings to attract investment.⁴⁶⁶ Behaviours such as those described above indicate that these company directors lacked integrity.

Enron directors reneged on their duties and responsibilities, which contributed to ineffectiveness in the governance of the company. There are various accounts of huge salaries and bonuses earned by the executives, with Andrew Fastow earning over \$30 million in management fees for his partnerships.⁴⁶⁷ They indulged in selling off their own shares whilst telling other employees that the company was

⁴⁶³ See C.W. Thomas, ‘The Rise and Fall of Enron’ (2002) 193(4) *Journal of Accountancy* 41-53.

⁴⁶⁴ See J.R. Macey, ‘Efficient Capital Markets, Corporate Disclosure and Enron’ (2004) 89 *Cornell Law Review* 394; see also Wearing, (note 2) 69; see also Mclean & Elkind, (note 129) 120.

⁴⁶⁵ See Mclean & Elkind, (note 129) 120-121.

⁴⁶⁶ See Arnold & De Lange, (note 141) 757.

⁴⁶⁷ See Wearing, (note 2) 70; see also Mclean & Elkind, (note 129) 122.

performing optimally even up till just weeks before they filed for bankruptcy.⁴⁶⁸ Aside from the obvious cases of numerous job losses and financial crippling of employees that the Enron collapse brought about, many other companies were affected by its failure, examples include Arthur Andersen (its auditors), JP Morgan Chase, Citigroup and Merrill Lynch (particularly for some transactions relating to Nigerian electricity generating barges).⁴⁶⁹ One of the most far reaching consequences of the fall of Enron would be the death of one of its former executives, J Clifford Baxter. He had complained to the CEO about questionable accounting practices within Enron, but, upon being called to testify before the United States Congress, he committed suicide in order to avoid the embarrassment.⁴⁷⁰

From the foregoing examples of the actions of Enron directors and executives, it is argued that if their behaviour had been more appropriate and in conformity with corporate governance guidelines and processes, the problems which occurred at the company might have been prevented or mitigated. Also, had there been an effective risk mitigating mechanism in place to check their behaviour owing to the potential which exists that they are persons who are prone to making inappropriate decisions, the collapse of Enron might have been averted. For example, the decision to falsify accounts is one which clearly reflects that the directors were not honest persons and that, amongst other factors, was a major reason for the failure of Enron. In the original indictment of the Enron executives, Richard Causey, Kenneth Lay and Jeffrey Skilling were charged on 53 counts with various issues ranging from issuing fraudulent and misleading statements, conspiracy, securities fraud, money laundering, bank fraud, wires fraud and insider trading.⁴⁷¹ The Enron Examiners' Report also concluded that certain senior officers engaged in wrongful conduct and violated their duty of loyalty to the company.⁴⁷² In the US Senate Report on the role of the Enron Board of Directors, it was stated that the directors breached their fiduciary duties because they witnessed numerous indications of questionable

⁴⁶⁸ Ibid.

⁴⁶⁹ See Wearing, (note 2) 77-80.

⁴⁷⁰ See R. Tomasic, 'Corporate Collapse, Crime and Governance- Enron, Andersen and Beyond' (2002) 14 *Australian Journal of Corporate Law* 183.

⁴⁷¹ See the full indictment document at

<http://f11.findlaw.com/news.findlaw.com/hdocs/docs/enron/usvlay70704ind.pdf> (accessed 15th June 2012).

⁴⁷² See the Examiners' Report (Role of Enron's Officers) at

<http://f11.findlaw.com/news.findlaw.com/hdocs/docs/enron/enronbk72803app-c.pdf>, 94-95 (accessed 15th June 2012).

practices by Enron management executives over several years but chose to ignore them to the detriment of the company shareholders, employees and business associates.⁴⁷³

The US Senate Report concluded that the board of directors contributed to the failure of Enron because the issues which plagued the company such as high risk accounting practices, inappropriate conflict of interest transactions, extensive undisclosed off the book transactions and excessive executive compensation were all facts within the knowledge of the directors who failed to provide sufficient oversight and restraint of management excesses as required by their obligations.⁴⁷⁴ In May 2006, Jeffrey Skilling was found guilty on 19 counts of conspiracy, fraud, false statements and insider trading. Kenneth Lay was found guilty on 6 counts of conspiracy and fraud; and in a separate bench trial, Judge Sim Lake also ruled that Mr Lay was guilty of 4 counts of fraud and false statements. After the original indictment, Richard Causey pleaded guilty. Kenneth Lay died in July 2006 before sentencing was concluded and before a notice of appeal could be filed, and therefore the court vacated his conviction and dismissed his indictment upon a motion brought by his estate.⁴⁷⁵ The final judgment and sentencing was made in respect of Jeffrey Skilling who was committed to an imprisonment term of 292 months.⁴⁷⁶

Jeffery Skilling appealed against his conviction on grounds which included that he did not get a fair trial from the jury which was constituted in Houston, the venue of the crime and the court proceedings. In June 2010, the US Supreme Court vacated his appeal on the grounds of a fair trial but upheld his appeal on the grounds of the honest services statute upon which his conspiracy conviction was based.⁴⁷⁷ The jurors in the first trial noted the flaw in the character and personality of the Enron

⁴⁷³ See the Senate Report at <http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/enron/senpsi70802rpt.pdf>, 3 (accessed 15th June 2012).

⁴⁷⁴ See the Senate Report, Ibid 59.

⁴⁷⁵ See the Order of Vacation at <http://www.txsb.uscourts.gov/notablecases/enron/404cr25/laydismissal.pdf> (accessed 15th June 2012).

⁴⁷⁶ See the Judgment and Sentencing at <http://www.txsb.uscourts.gov/notablecases/enron/404cr25/judgment.pdf> (accessed 15th June 2012).

⁴⁷⁷ See the US Supreme Court Opinion at <http://www.supremecourt.gov/opinions/09pdf/08-1394.pdf> (accessed 15th June 2012).

executives.⁴⁷⁸ The jurors simply refused to believe that the executives were telling the truth when Jeffery Skilling and Kenneth Lay claimed that they did not know that things were going wrong at Enron. The jurors noted that it was appalling that Mr Lay was selling his own Enron shares even as he assured employees and shareholders that the company was fiscally sound. One of the jurors commented as follows “that was very much the character of the person that he was....”⁴⁷⁹ The jurors stated that Mr Lay put his personal financial welfare ahead of his duties to the shareholders and employees.⁴⁸⁰ The perception of the jurors is quite valid, considering the behaviour of the Enron directors and how it contributed to that corporate failure.

4.3.5 WORLDCOM

The United States experienced another major corporate collapse in July 2002 with the bankruptcy of WorldCom. The Securities and Exchange Commission had been investigating accounting irregularities at the company, culminating in the admission by the company to falsifications in its accounts.⁴⁸¹ Bernie Ebbers, the former CEO was charged with fraud, conspiracy and making false statements in relation to the accounts; while Scott Sullivan, the former CFO agreed to plead guilty to similar charges.⁴⁸² In the late 1990s, WorldCom was one of the largest companies in the world and its CEO had become a spend-thrift, buying up ranches, yachts and timberlands; in addition to collecting loans from the company at ridiculously low interest rates.⁴⁸³ There were also indications that he and his CFO clearly dominated the board of directors.⁴⁸⁴ The actions of the CEO appeared to be unprofessional in many instances and a typical example is the issue of obtaining loans from the company at unfair interest rates.⁴⁸⁵ The failure of WorldCom resulted in a huge loss of confidence on the part of investors. It also had devastating effects on the residents of Mississippi in the United States, the home state of the company and the

⁴⁷⁸ See the article in the New York Times, 26th May 2006 ‘Enron Jury Unswayed by “I Didn’t Know”’ at <http://www.nytimes.com/2006/05/26/business/businessspecial3/26jury.html> (accessed 15th June 2012).

⁴⁷⁹ Ibid.

⁴⁸⁰ Ibid.

⁴⁸¹ See Wearing, (note 2) 83.

⁴⁸² See *The Financial Times*, 4th March 2004, p 28.

⁴⁸³ See Wearing, (note 2) 88.

⁴⁸⁴ See Wearing, *ibid* 92.

⁴⁸⁵ See Wearing, *ibid* 88.

CEO because a lot of those residents had in the spirit of solidarity invested all their financial possessions in WorldCom shares and refused to exit the company until their shares became invariably worthless.⁴⁸⁶

Again, if the directors at WorldCom had behaved more appropriately by being honest and professional in relation to their corporate accounts and dealings, there might have been a more effective corporate governance process in the company and this might have helped prevent or mitigate the corporate failure. Bennie Ebbers was indicted,⁴⁸⁷ and convicted in March 2005 of securities fraud, conspiracy and filing false documents with regulators.⁴⁸⁸ Scott Sullivan, the former CFO at WorldCom testified against his boss reiterating that he was acting under his instructions.⁴⁸⁹ In July 2005, Ebbers was sentenced to 25 years imprisonment.⁴⁹⁰ Judge Barbara Jones of the Federal District Court in Manhattan who handed down the sentence stated that Mr Ebbers was the instigator of the \$11 Billion fraud.⁴⁹¹ In rebutting arguments that Mr Ebbers was deceived by his subordinates, she stated that “Mr Ebbers’s statements deprived investors of their money. They might have made different decisions had they known the truth”.⁴⁹² This statement underscores the importance of shareholders being in possession of accurate and relevant information regarding their investee companies as it impacts on their decision making in relation to the company.

⁴⁸⁶ See Jeter, (note 130) 91.

⁴⁸⁷ See the indictment at <http://news.corporate.findlaw.com/hdocs/docs/worldcom/usebbers504ind3s.pdf> (accessed 15th June 2012).

⁴⁸⁸ See the report of the conviction at http://www.forbes.com/2005/03/15/cx_da_0315ebbersguilty.html (accessed 15th June 2012).

⁴⁸⁹ See the report at <http://money.cnn.com/2005/03/15/news/newsmakers/ebbers/> (accessed 15th June 2012).

⁴⁹⁰ See the report at <http://www.msnbc.msn.com/id/8474930/ns/business/t/ebbers-sentenced-years-prison/> (accessed 15th June 2012).

⁴⁹¹ See the article in the New York Times, 14th July 2005 ‘WorldCom Chief is Given 25 Years for Huge Fraud’ at <http://www.nytimes.com/2005/07/14/business/14ebbers.html?scp=12&sq=WorldCom%20court%20case&st=cse> (accessed 15th June 2012).

⁴⁹² See New York Times Article, Ibid.

4.3.6 LEHMAN BROTHERS

The story of Lehman Brothers is another case in which disobedience of established rules and principles clearly contributed to the company's failure.⁴⁹³ The Lehman Examiners' Report states categorically that there are legitimate claims against the CEO, CFO and other officers who oversaw and certified misleading financial statements which in turn contributed to the demise of the company.⁴⁹⁴ Again, in this case as in some of the previous examples, there was falsification of financial records and there were also instances of the Lehman Brothers officers exhibiting clearly inappropriate behaviour, an example of which was terminating the employment of one of its staff who blew the whistle on certain accounting abuses.⁴⁹⁵ The company was described as one with an "unethical" tone at the top, a reflection of the character and behaviour of the company directors who governed it.⁴⁹⁶ For instance, Section 401 of the Sarbanes-Oxley Act clearly provides for disclosures relating to off-balance sheet items, yet the Lehman Brothers directors flouted that rule and this was a contributory element to the failure. If the directors at Lehman Brothers had been persons who were prone to obeying rules, they would have abided by the provisions of the Sarbanes-Oxley Act, and this might have prevented some of the problems which ensued.⁴⁹⁷

Again, the act of terminating the employment of a whistle blower is an indication of a situation in which the executives were involved in obvious wrong doings and were taking steps to cover up their actions. The Lehman Examiners' Report analyses in full the events that led to the failure and one of the significant issues raised is that Lehman's financial problems and the consequences to its creditors and shareholders were exacerbated by Lehman executives whose conduct ranged from serious but non culpable errors of business judgment to actionable balance sheet manipulation.⁴⁹⁸ Therefore, the behaviour of the directors was clearly a major contributory factor to the Lehman Brothers failure. This corporate failure became the largest bankruptcy

⁴⁹³ See Black, (note 132).

⁴⁹⁴ See The Lehman Examiners' Report, (note 131) Vol 1, 17 & 20.

<http://lehmanreport.jenner.com/VOLUME%201.pdf> (accessed 15th June 2012).

⁴⁹⁵ Ibid; see also Black, (note 132).

⁴⁹⁶ See Black, Ibid.

⁴⁹⁷ See The Lehman Report, (note 131) 3.

⁴⁹⁸ Ibid.

proceeding ever filed as at September 2008.⁴⁹⁹ Even though Lehman Brothers took out insurance policies to indemnify the company and executives for liability and settlements arising from law suits, the economic and social losses accruing from the failure was nevertheless enormous.⁵⁰⁰

4.3.7 RBS

The Financial Services Authority (FSA) issued a report on the failure of the Royal Bank of Scotland (RBS) which stated that: “RBS’s failure in October 2008 has imposed large costs on UK citizens. To prevent collapse, the government injected £45.5bn of equity capital, that stake is now worth about £20bn. But this loss is only a small part of the cost resulting from the financial crisis. The larger costs arise from the recession which resulted from that crisis, within which RBS’s failure played a significant role. That recession has caused unemployment for many, losses of income and wealth for many more.”⁵⁰¹ This is one example of the impact a corporate failure can have on society generally. In the same report, it was highlighted that one of the contributory factors to the RBS failure was poor decisions by its board and management which resulted from flawed analysis and judgment; and that a pattern of decisions that may reasonably be considered poor suggests the probability of underlying deficiencies in issues such as the bank’s management capabilities and style, governance arrangements, checks and balances, mechanisms for oversight and challenge, and in its culture, particularly its attitude to the balance between risk and growth.⁵⁰²

Culture was defined in the report to connote a set of attitudes, values, goals and practices which together determines how a firm behaves, and a particular culture can have a significant influence on the decision-making of a firm.⁵⁰³ The report notes that there was no evidence of failings in formal governance processes at RBS, but

⁴⁹⁹ See The Lehman Report, (note 131) 2.

⁵⁰⁰ See The Article ‘Fight for Lehman Insurance’ in the Wall Street Journal, 10th September 2011 <http://online.wsj.com/article/SB10001424053111903285704576560692379898996.html> (accessed 15th June 2012).

⁵⁰¹ See ‘The Failure of the Royal Bank of Scotland’, Financial Services Authority Board Report, December 2011, <http://www.fsa.gov.uk/pubs/other/rbs.pdf>, 6 (accessed 15th June 2012).

⁵⁰² See the FSA Report, *ibid* 26.

⁵⁰³ See the FSA Report, *ibid* 223.

the board were ultimately responsible for a sequence of decisions and judgments which contributed to the failure, and therefore it is concluded that there were substantive failures of board effectiveness at RBS.⁵⁰⁴ Interestingly, the reports also stated that prior to the crisis; the FSA had identified a risk created by the perceived domineering behaviour of the CEO at RBS.⁵⁰⁵ Behavioural issues were part of the problem at RBS. In relation to the underlying deficiencies noted above, management capabilities and style, as well as culture, are factors which particularly reflect behavioural tendencies.⁵⁰⁶ It is also noteworthy that the report highlights that even when governance processes are in place, behavioural issues can affect overall board effectiveness. Again, the report acknowledges the existence of behavioural risks by stating that the FSA had indeed identified a risk resulting from the behaviour of the RBS CEO.

4.4 JUDICIAL AND SOCIETAL PERSPECTIVES

Court cases following corporate failures often highlight the role played by the company directors in the lead up to the failure. In the Enron case, the jurors pointed out that the directors lied and were not dutiful in their role.⁵⁰⁷ The WorldCom case also highlights the fact that the CEO lied.⁵⁰⁸ These directors were clearly dishonest persons, and also had the ability to, and, actually contravened established corporate rules and principles. In the WorldCom trial, the judge noted that the long sentence was commensurate with the damage caused by the wrongdoing which led to the collapse, and that the government hoped that it would serve as deterrence for corporate leaders in the future.⁵⁰⁹ The recent Lehman Brothers failure illustrates that this may not be the case. The Lehman directors were also found wanting in their behaviour and the examiners noted that there were legitimate claims against them for falsifying company accounts.⁵¹⁰ The Lehman case has semblances of the Enron scandal, an indication that the reforms which occurred after that scandal and were

⁵⁰⁴ See the FSA Report, *ibid* 225.

⁵⁰⁵ See the FSA Report, *ibid* 233.

⁵⁰⁶ It has been discussed earlier and will be discussed in more detail in chapter five that personality contributes to behaviour, and behavioural tendencies are reflected in actions and decisions; see the FSA Report, *ibid* 223.

⁵⁰⁷ See the New York Times Article, (note 478).

⁵⁰⁸ See the report of the conviction, (note 488).

⁵⁰⁹ See the report of the sentence and the New York Times Article, (note 490 & 491).

⁵¹⁰ See The Lehman Report, (note 131) 3.

aimed at preventing future occurrences of similar scandals may not actually be effective in all respects.⁵¹¹ The judge in the WorldCom trial also noted that investors were deceived, and they might have made different choices regarding their investment in the company if they had known the truth.⁵¹² That is true, especially to the extent that accurate information is essential for the effective functioning of the capital market as it enhances the ability of investors to make adequate and rational choices.

4.5 CONSEQUENTIAL ISSUES

A close examination of the cited examples of corporate failures shows a recurrent pattern of company directors taking actions and making decisions that either wholly or substantially contributed to the demise of their companies. In the quest to establish mechanisms which might help prevent future corporate failures attributable to the behaviour of directors, one important aspect of the governance process which should ordinarily play a significant role in the determination of the calibre of people who are allowed to govern companies is the recruitment process. There is a possibility that shareholders as investors might prefer the recruitment in companies of persons who have the ability to take risks which are likely to increase returns on their investment.⁵¹³ It is agreed that every business involves elements of risk taking and the popular saying comes to mind that “the higher the risk, the higher the return”. However, in the interest of all stakeholders in a company, including the shareholders, and for the survival of companies, it is essential to recruit persons who would take risks within the ambit of prescribed rules and regulations in the business. Essentially, the rules which operate in companies are instituted to safeguard the company from the risks which are not likely to yield “higher returns”, but might actually result in corporate failure.⁵¹⁴ Therefore, company directors need to be

⁵¹¹ See the article in the New York Times, 12th March 2010 ‘In Lehman’s Demise Some Shades of Enron’ at <http://dealbook.nytimes.com/2010/03/12/in-lehmans-demise-some-shades-of-enron/> (accessed 15th June 2012).

⁵¹² See the New York Times Article, (note 491).

⁵¹³ See Dine, (note 49) 30-31; see also Webb, Beck & McKinnon, (note 58) who argue that shareholders are often focused on profits.

⁵¹⁴ See the Revised Turnbull Guidance, (note 170) 3 where it is indicated that profits are in part a reward for risk taking, but that internal control is supposed to help manage and control corporate risks appropriately.

persons who can manage the companies and take the risks which are within the agreed parameters.

The examples of corporate failures cited here show that most of them resulted from company directors pushing against acceptable boundaries of behaviour. There were numerous cases of falsification of accounts, misappropriation of funds and lack of appropriate disclosures; all these being examples of situations which corporate rules are usually established to guard against. However, rules and regulations can only be effective if and when they are obeyed. In the case that a company recruits directors who are not dutiful and they decide, for instance, to function outside the rules established for the governance of the company, the result can only be negative. It therefore becomes vital to the effective operation of the corporate governance process to recognise this inherent risk, and develop mechanisms which ensure that directors are persons who will govern companies in the manner envisaged by corporate rules and principles or at the least mitigate the risk of not recruiting such appropriate persons by developing personality and behavioural risk mitigating mechanisms.

Solomon questions how the issue of ethics in the boardroom can be monitored and controlled,⁵¹⁵ but, one answer to that question rests simply in recruiting board members who are inherently ethical or ensuring one way or another that those who are not so would stand the least risk of being in a position to manifest behaviours which are unethical and therefore inimical to the success of the company. In relation to the recent financial crisis, some commentators have suggested that the crisis is a phenomenon resulting from “gate-keeper” failures, the term essentially referring to the persons who are supposed to guard the company from breakdowns.⁵¹⁶ Therefore, it is increasingly evident that mechanisms must be developed to ensure that the risks which accrue from inappropriate behaviours in corporate governance are effectively managed. Otherwise, there could be a continuation of the recurring cases of corporate failures in which company directors make decisions and take actions which lead to corporate failures. In the bid to manage behavioural risks, there is the option of avoiding the risk in the first instance by ensuring that there is

⁵¹⁵ See Solomon, (note 433) 48.

⁵¹⁶ See Tomasic, (note 132); see also Coffee, (note 132).

no room for inappropriate behaviour on the part of company directors.⁵¹⁷ There is also the option of mitigating the risk by accepting board members who have potentially risky behavioural tendencies into governance, but taking adequate steps to ensure that all actions and decisions undertaken by such persons are risk managed, such that there is minimal room for them to consummate actions which may result in corporate failure.⁵¹⁸

From the examples of the actions of directors discussed in the examples of corporate failures above, it is not surprising that there has been an emphasis on the character and behaviour of company directors in the reports which followed the recent corporate scandals. Clearly, these behavioural issues have been highlighted in a bid to solicit solutions to the problem with the aim of preventing future occurrences of corporate failure which are attributable to behavioural flaws. Behavioural issues have been a major contributory factor in a number of major corporate failures and corporate governance mechanisms have been geared towards finding solutions to issues which lead to corporate failures.⁵¹⁹ In fact, as stated earlier, corporate governance in itself emerged as a major issue in the UK following corporate collapses of the early 1990s.⁵²⁰ Committees such as Cadbury made proposals for the adoption of principles which were aimed at helping to prevent future occurrences of corporate failures. Clearly, further corporate failures occurred, particularly in the US with Enron and WorldCom. There have also been so many other cases of corporate collapses and scandals ranging from small obscure companies with minimal impact to larger companies with more severe consequences; and occurring in various continents of the world. Examples include the cases of Polly Peck, Parmalat, Barings Bank, Shell, Northern Rock, Tyco, One.Tel, Ansett Airlines, Sumitomo, Lernout & Hauspie, Sunbeam and Xerox.⁵²¹

⁵¹⁷ As discussed in chapter three, personality risks contribute to behavioural risks. Risk management processes were also discussed in that chapter and chapters six and seven present approaches for personality risk management in detail.

⁵¹⁸ Ibid.

⁵¹⁹ See the examples of Maxwell Group Plc, BCCI Plc, Enron and WorldCom discussed earlier. The first UK corporate governance code and the Sarbanes-Oxley Act were promulgated in the aftermath of these failures.

⁵²⁰ See The Cadbury Committee Report; see also Cadbury, (note 122) 7.

⁵²¹ See A. Melis, 'Corporate Governance Failures: To What Extent is Parmalat a Particularly Italian Case?' (2005) 13(4) *Corporate Governance: An International Review* 478-488; see also Andrew, Cooper & Islam, (note 141) ; see Wearing, (note 2); see also R. Tomasic, 'Corporate Rescue, Governance and Risk-taking in Northern Rock: Part 1' (2008) 29(10) *Company Lawyer* 297-303.

There have also been an increasing number of reforms aimed at improving corporate governance, each mostly tackling the supposed emergent issues from the most recent corporate failures. After the Enron scandal, there were committees set up in the UK to investigate and propose reforms for internal control and for audit committees.⁵²² In the US, the Sarbanes-Oxley Act was introduced. One salient issue to note is that most of these corporate governance reforms have often focused on enhancing the structural elements of the governance process. For instance, the Cadbury Committee focused on issues such as board structure and composition, board meetings, committees etc. The UK Corporate Governance Code focuses on those same issues in the main. There has been no elucidation of principles and recommendations relating to the behaviour of company directors. The UK Corporate Governance Code states clearly in its preface that the code is only a guide in general terms as to principles, structures and processes, and cannot guarantee board behaviour.⁵²³ The problem with this approach is that considering the impact of board behaviour on governance outcomes, it becomes increasingly arguable that mechanisms should be developed which are aimed at ensuring appropriate board behaviour. It is important to place as much emphasis on board behaviour as is placed on board structure if an overall system of effective corporate governance is to be attained.

It is inimical to corporate success if far less focus is placed on the behaviour of company directors who invariably bring all the corporate structures to life.⁵²⁴ Internal control systems and risk management processes can only become effective to the extent that they are utilised. It is appropriate to utilise processes which have been instituted in corporate governance, but then, it is persons who behave appropriately who are likely to do so. Appropriate behaviour in corporate governance essentially connotes conformity with the acceptable standard of behaviour which is suitable for corporate governance, as the word “appropriate” means suitability for the purpose.⁵²⁵ Therefore, foundational to the development of

⁵²² See The Turnbull Guidance (note 169) and The Smith Guidance-FRC Guidance on Audit Committees <http://www.frc.org.uk/corporate/auditcommittees.cfm> (accessed 15th June 2012)

⁵²³ See The UK Corporate Governance Code 2010.

⁵²⁴ See Ees, Gabrielsson & Huse, (note 139); see also Bragues, (note 136).

⁵²⁵ See the Oxford Dictionary <http://oxforddictionaries.com/definition/appropriate> (accessed 15th June 2012), which defines appropriate as “suitable or proper in the circumstances”.

more effective processes is the development of mechanisms which ensure the utility of those processes. The examples of corporate failures discussed earlier illustrate that inappropriate behaviour occurs despite the existence of corporate governance mechanisms. It is not enough for a company to institute effective systems and processes because actual performance and eventual outcomes are determined by how the people in the company engage with the structures in place. Behaviour turns systems and processes into reality.

Some of the reports considered have made recommendations in respect of “appropriate behaviour” by corporate boards. However, the more pertinent issue is implementing these recommendations. At present, the UK Corporate Governance Code has no specific provisions relating to behaviour. It is agreed that there are numerous factors which may impact on the establishment of a definitive approach to the problem such as the fact that under the present system of corporate governance which is underpinned by the contractual theory of corporations, the shareholders and the company board retain most of the decision making powers and State interference in the form of establishing rules for the internal management of companies is discouraged and at best grudgingly accepted. The committees which are set up to investigate and issue reports after corporate failures may be constituted by the State, but it is doubtful that their recommendations are implemented without recourse to the opinions of market participants such as shareholders and company directors.⁵²⁶ In this case, it might be that shareholders are yet to fully understand the impact of the behaviour of company directors on the success or failure of their companies. If shareholders had a full grasp of the implications of behavioural issues in corporate governance, then the chances are higher that they would realise that there is an enormous difference in the risks of corporate failure which is made by their choice of company directors. It would then become vital to shareholders the kinds of personalities they allow into and retain in the governance of their companies. In a perfect market which connotes one in which all vital information is readily available,⁵²⁷ the information relating to the behavioural tendencies of prospective directors becomes one which is essential in the decision to invest in a company.

⁵²⁶ The FRC consults with the business community, see <http://www.frc.org.uk/corporate/2009DecConsultationamendments.cfm> (accessed 15th June 2012).

⁵²⁷ See Cheffins, (note 375).

Also, shareholders who are interested in the long term success of their companies would no doubt lean in the direction of mitigating behavioural risks.⁵²⁸ As was argued earlier, even in the case that there is no clear evidence that appropriate behaviour would lead to corporate success, there is clear evidence that inappropriate behaviour would lead to corporate failure.⁵²⁹

It is trite that company directors have been prone to recruiting themselves based on the old boys' syndrome.⁵³⁰ Cadbury highlighted that word of mouth or personal network approach to the selection of directors has been the traditional mode of recruiting directors, and he argued that such approaches should be increasingly unacceptable, but also acknowledges that old habits die hard and patronage breeds power and influence.⁵³¹ Recent reports indicate that company directors are still being recruited through personal network approaches, and only a minority of nominations committees focus on descriptors of high performance.⁵³² Essentially, traditional methods of director selection still prevail.⁵³³ More formal and rigorous approaches would prove better at ensuring the selection of the most appropriate company directors.⁵³⁴ But, considering the fact that directors have shown resistance to evaluation processes due to reasons such as individual humiliation and exposure,⁵³⁵ one can expect that they might be opposed to the idea of their personality and behaviour being scrutinized. Again, considering the traditional mode of director selection, there could be a limited pool from which directors are drawn, and so there might be apprehensions regarding the establishment of further supposed "bottle necks" in the recruitment process, however, this process is a seriously needful "bottle neck". In the UK for instance, company directors in the financial sector

⁵²⁸ Risks which are unmanaged could result in adverse effects for the company and truncate corporate goals, see Van der Elst & Van Daelen, (note 274); see also the Revised Turnbull Guidance, (note 170) 7, it should make a difference if shareholders had knowledge of this fact in relation to personality and behavioural risks, and it should influence their choice of directors and risk management processes in that regard.

⁵²⁹ See Solomon, (note 433) 72.

⁵³⁰ See Cadbury, (note 225).

⁵³¹ Ibid.

⁵³² See Dulewicz & Herbert, (note 224).

⁵³³ Ibid.

⁵³⁴ See Cadbury, (note 225).

⁵³⁵ See Long, (note 154); see also Ingley & Van der Walt, note (156); see also Kazanjian, (note 157) who notes that directors are generally reluctant to be assessed.

undergo assessments to determine whether they are fit and proper for the role.⁵³⁶ This thesis argues for such recruitment scrutiny to occur in all public companies which trade on funds from the public and in which the State is a stakeholder on behalf of the general public. This is because the State under the contractual and concession theories of companies has a responsibility to ensure that markets are functioning effectively.⁵³⁷ If there is an area of corporate governance which has been identified as porous and prone to create problems, such as behavioural issues, then such areas should be tackled as effectively as possible, regardless of the interests of persons other than the society as a whole. The role of law in a society should also be considered in relation to the interests of entrepreneurs and company shareholders.⁵³⁸ The State has a role in preventing corporate failures in order to ensure that the economy is functioning effectively, so that there is enhanced quality of living within the society, and there are jobs, capital for businesses, and markets to access goods and services.⁵³⁹

Central and most vital to solving the problems associated with behavioural issues in corporate governance is ascertaining what contributes to inappropriate behaviour. Some of the examples of corporate failures examined earlier highlighted some linkage between personality and the inappropriate behaviour of corporate officers.⁵⁴⁰ That is an indication that personality impacts on behaviour. If behavioural issues are risks to the corporate governance process for the reason that they have the potential to affect the achievement of corporate goals and objectives, then personality is also a risk to the corporate governance process as it has the potential to impact on behaviour. The previous chapter demonstrates that corporate governance mechanisms have largely ignored the issue of personality risks. The examples of corporate failures and the reports analysed in this chapter have indicated how pertinent behavioural issues are in affecting corporate governance mechanisms and

⁵³⁶ See The Financial Services Authority (FSA)'s Approved Persons Regime. The FSA is set up under the Financial Services and Markets Act (FSMA) 2000. The Regime is discussed in more detail in chapter seven, section 7.3.1.

⁵³⁷ See Dine, (note 49).

⁵³⁸ See Hansmann & Kraakman, (note 233) who argue that the role of law is to serve the interests of society as a whole.

⁵³⁹ See C. Coglianese, T. Healey, E. Keating & M. Michael, 'The Role of Government in Corporate Governance' (2004) 1 *New York University Journal of Law and Business* 219.

⁵⁴⁰ For instance, the Maxwell Group Plc report, the HIH Group report and the RBS report highlighted the issue of domineering personalities.

outcomes. As personality is a factor which impacts on behaviour, then it is worth investigating how it does so. This way, the exact impact of personality risks in corporate governance becomes clearer.

In order to develop mechanisms which are geared towards ensuring that appropriate behaviours occur in a corporate governance context, it is also important to ascertain which aspects of personality contribute to the situations of appropriateness envisaged in corporate governance. In the wider process of seeking to prevent corporate failures attributable to behavioural issues, identifying and managing personality risks is key. There might be other factors which impact on behaviour, such as situations, but the focus of this thesis is on the personality aspect of behaviour. This is because situations are largely dealt with by processes as already highlighted in relation to internal controls in section 3.4, so the gap which exists relates more to personality. The fact that there have been continuous reforms in the area of processes and corporate failures have still occurred which are attributable to behavioural issues is a reason why there needs to be an emphasis on the gap created by the absence of mechanisms to manage personality risks in corporate governance. For the reason that personality has a significant impact on behaviour, as will be illustrated in detail in the next chapter, then there can be no meaningful attempt at managing behavioural risks if personality risks are not managed as well.

4.6 CONCLUSION

This chapter has illustrated the impact of behavioural issues and invariably behavioural risks in corporate governance. Examples of corporate failures, as well as reports issued after investigations into such failures were examined in order to illustrate that personality risks and in turn behavioural risks are significant problems in corporate governance and have been contributory elements in corporate failures. The chapter has also highlighted a linkage between personality and behaviour, and indicates that personality risks must be identified and managed in the bid to manage behavioural risks. The next chapter investigates personality in detail from a psychological perspective, discussing what personality entails, establishing the significant linkage between personality and behaviour, illustrating the means of identifying personality dimensions, and presenting arguments regarding the personality dimensions best suited to delivering effective corporate governance.

CHAPTER FIVE

PERSONALITY AND CORPORATE GOVERNANCE

5.1 INTRODUCTION

Chapter four discussed the problems associated with behavioural issues in relation to corporate governance, particularly in respect of corporate failures, and highlighted that the personality of company directors impacts on their behaviour. The purpose of this chapter is to draw on ideas established in psychology research as a foundational basis for understanding what personality entails and the linkage between the personality of company directors and their behaviour in delivering effective corporate governance. This chapter also illustrates that it is possible to identify different personality types, and that the choice as to who should be recruited as directors can be made in such a manner as to give reasonable assurance that the most appropriate persons are appointed to positions with responsibility for the delivery of effective corporate governance. The ability to identify personality dimensions also enables an identification of the risks associated with inappropriate personality traits, and contributes towards managing those risks. There is also an analysis of the impact of personality dimensions on leadership and job performance roles, as well as arguments regarding the personality dimension best suited to delivering effective corporate governance.

5.2 WHAT IS PERSONALITY?

In 1930, Allport & Vernon in a review of 327 articles noted that “there seem to be virtually as many definitions of personality, character and temperament as there are writers on these subjects”.⁵⁴¹ It may be that the personalities of the persons engaged in an exercise of articulating a definition of the term “personality” actually impacts on the outcome of the exercise, such that different views of the term emerge as there are differences in personalities. There are indeed various approaches to the concept of personality and this makes a univocal definition of the term a challenging task.⁵⁴² For instance, there are the trait based Five-Factor model of personality analysis,⁵⁴³ the experimental analysis of the psychophysiological basis of personality,⁵⁴⁴ analysis of prototypic acts and act frequencies,⁵⁴⁵ psychodynamic

⁵⁴¹ See G.W. Allport & P.E. Vernon, ‘The Field of Personality’ (1930) 27(10) *Psychological Bulletin* 677-730.

⁵⁴² See P. Hartmann, ‘The Five-Factor Model: Psychometric, Biological and Practical Perspectives’ (2006) 58(2) *Nordic Psychology* 150-170 at 150.

⁵⁴³ See McCrae & Costa, (note 134).

⁵⁴⁴ See H.J. Eysenck & M. Eysenck, *Personality and Individual Differences* (London: Plenum Press 1984).

formulations,⁵⁴⁶ and behavioural genetics,⁵⁴⁷ all different approaches to the issue of personality. Personality cannot be considered in its totality using one single approach, and most personality researchers develop structural components into which facets of personality are divided and then seek to determine their individual elements and inter-relationships.⁵⁴⁸ However, considering the factors that are most relevant for describing and explaining personality, some possible definitions emerge.

Allport had explained personality trait in three stages as (i) an independent statistical variable (ii) a dynamic trend of behaviour that results from the integration of numerous specific habits (iii) a general habitual mode of adjustment that has a directive influence upon specific responses.⁵⁴⁹ Allport suggests that personality as a whole should be defined as a matter of degree of occurrence of particular traits. This means that a person should be adjudged to be of a certain personality in the case that there is evidence of recurring traits which indicate that personality type more than any other. This analysis also presupposes that an individual may display certain personality traits some of the time, but not enough times to be adjudged as a person of the personality type which is represented by those traits if he/she displays certain other personality traits in a more frequent degree. This would probably hold true especially if the personality traits in question are contradictory. For instance, a person who is accustomed to acting kindly towards others may generally and more accurately be described as a kind person, although he/she may actually display acts of unkindness sometimes. Therefore, the crux of judgments as to personality according to Allport's explanation rest on the frequency of display of the personality traits in question.

⁵⁴⁵ See D.M. Buss & K.H. Craik, 'The Act Frequency Approach to Personality' (1983) 90 *Psychological Review* 105-126.

⁵⁴⁶ See K. Horney, *Our Inner Conflicts* (New York: Norton 1945).

⁵⁴⁷ See R. Plomin, J.C. DeFries & G.E. McClearn, *Behaviour Genetics: A Primer* (San Francisco: Freeman 1980); see also J.C. Loehlin, *Genes and Environment in Personality Development* (Newbury Park, CA: Sage 1992). For various insights on the physiological aspects of personality addressing issues such as genetics and neuroscience, see T. Canli (ed.), *Biology of Personality and Individual Differences* (New York: The Guilford Press 2006).

⁵⁴⁸ See J.D. Mayer, 'Structural Divisions of Personality and the Classification of Traits' (2003) 7(4) *Review of General Psychology* 381-401 at 381.

⁵⁴⁹ See G.W. Allport, 'Concepts of Trait and Personality' (1927) 24(5) *Psychological Bulletin* 284-293.

Schultz & Schultz state that personality is “the unique, relative enduring internal and external aspects of a person’s character that influence behaviour in different situations”.⁵⁵⁰ From this definition, it can be discerned that personality is relative to an individual, relatively constant, and has an impact on the behaviour of that individual. Again, this definition highlights that personality remains relatively constant even though behaviour may vary over different situations. An example would be the case of an individual who is generally adjudged to be of a domineering personality. In a situation where that individual is a subordinate, problems might arise as a result of his/her reluctance to obey instructions emanating from a process in which his/her contributions were not adopted. Also, in situations where the domineering individual is a superior, problems may also arise if subordinates disagree with his/her opinions or instructions. So, the individual’s domineering personality is evident in differing situations.

Personality is also portrayed in both intrinsic and extrinsic characteristics.⁵⁵¹ The intrinsic elements of personality represent the internal evidence of personality traits whilst the external elements represent the outward display of the traits. Hogan notes that the term “personality” is usually used to refer to either of two elements.⁵⁵² The first is the underlying structures, dynamics, processes and propensities that bring about certain behavioural regularities. The second is the way in which these behavioural regularities are observed and described by others in terms of their content. In other words the first element deals with the causal aspects and the second element deals with the descriptive aspects of personality. The descriptive element of personality has its roots in the lexical approach to personality analysis which culminated in the five-factor model of personality.⁵⁵³ The lexical approach to personality analysis utilizes words as the identifying element of traits, so that a projection and analysis of particular word/words becomes indicative of the presence of certain personality traits. Describing aspects of an individual’s personality entails references to the observable content of behavioural regularities. Hogan’s explanation as to what constitutes personality again brings to the fore the impact of personality on actual behaviour. It also highlights the issue of “regularity” in terms of determining a particular behaviour as indicative of a particular

⁵⁵⁰ See Schultz & Schultz, (note 13) 195; see also E.J. Phares, *Introduction to Psychology* (3rd ed., New York: Harper Collins Publishers 1991) 4, where it is stated that personality is that pattern of characteristic thoughts, feelings and behaviour that distinguishes one person from another and that persists over time and situations.

⁵⁵¹ See R. Hogan, ‘Personality and Personality Measurement’ in M.D. Dunnette & L.M. Hough (eds.), *Handbook of Industrial and Organisational Psychology*, Vol 2 (Palo Alto, CA: Consulting Psychologists Press 1991) 873-919.

⁵⁵² Ibid.

⁵⁵³ Ibid.

personality. This would presuppose that an individual is adjudged as a certain kind of person because he/she acts in a particular way, more often than not. It would also mean that the same individual can be reasonably expected to continue to act in that same way from which a judgment as to his/her personality was obtained.

Brody & Ehrlichmann define personality as “those thoughts and feelings, desires, intentions and action tendencies that contribute to important aspects of individuality”.⁵⁵⁴ This definition highlights the possible trajectory of behaviour as emanating from within the individual in the form of thoughts, desires and intentions which may then culminate in actions and associated tendencies. Again, the relationship between personality and behaviour is direct. Regarding the exact influence of personality on behaviour, there are arguments that actual behaviour is dependent on both the personality of an individual and the given situation.⁵⁵⁵ Funder argues that every global personality trait is situation specific in the sense that it is relevant to behaviour in some but not necessarily all life situations.⁵⁵⁶ This would hold true because, for instance, an individual who is accustomed to arriving at work punctually in accordance with the regulations for employees may be adjudged a dutiful person because he/she abides by the obligation to obey the regulations. However, there might come some day when due to unexpected traffic congestion, this individual arrives later than usual and outside the regulated time of arrival for employees. The situation has clearly been altered by the traffic congestion, but, the personality of that individual would probably not have been altered, and were the situation to be normal, he/she is more likely to have arrived at the usual time based on which he/she was adjudged a dutiful person. Therefore, making clear judgments as to individual personality is a question of consistency, and though these judgments may be influenced by different situations, it is doubtful that the basic personality can be altered, with the various definitions of personality suggesting that personality is relatively stable over time.⁵⁵⁷

⁵⁵⁴ See N. Brody & H. Ehrlichmann, *Personality Psychology: The Science of Individuality* (New Jersey: Prentice Hall 1998) 3; see also R. Ryckman, *Theories of Personality* (2nd ed., Monterey, CA: Brooks/Cole Publishers 1982) 4-5, where it is explained that personality is a concept which is hypothetically understood as it is the sum of biologically based and learnt behaviour which forms the person's unique responses to environmental stimuli.

⁵⁵⁵ See B.W. Roberts, 'Back to the Future: Personality and Assessment and Personality Development' (2009) 43 *Journal of Research in Personality* 137-145 at 139; see also Trevino, (note 134); see also Funder, (note 13).

⁵⁵⁶ See D.C. Funder, 'Global Traits: A Neo-Allportian Approach to Personality' (1991) 2 *Psychological Science* 31-39.

⁵⁵⁷ As regards the issue of consistency and personality judgments, see W. Fleeson & E.E. Nofle, 'Where does Personality have its Influence?, A Supermatrix of Consistency Concepts' (2008) 76(6) *Journal of Personality*

Roberts analyses this cross-situational variance in personality by using an example of an authoritarian person who obeys all orders from a superior, and punishes subordinates for wrong doing, and so would obviously be prone to acting inconsistently in different situations.⁵⁵⁸ There is, however, no actual inconsistency in behaviour, because if authoritarians are known as people who possess those varying traits, it means they can obviously exhibit those different traits in different situations. The tendency to obey one's superior cannot be said to be totally inconsistent with the tendency to punish subordinates for wrong doing as the two actions are mutually exclusive behaviours of an individual who believes in and adheres to authority. If anything, it is reasonable and consistent to expect a person who is accustomed to obedience to also have the tendency to punish others for disobedience. It would have been a different situation if the argument regarding inconsistency is that an authoritarian person would obey superiors in certain situations and disobey them in others, with no clear consistency in either pattern of behaviour, in which case questions of inconsistent personality would be valid. Essentially, the issue of inconsistency as it relates to personality traits would be most significant in cases where there is a display of contradictory traits, as in a situation where an individual obeys instructions at certain times and disobeys instructions at certain other times making it difficult to reach a definitive judgement as to whether that individual is actually an obedient person or not. If the degree of frequency of display of a particular trait is not clearly higher than that of a contradictory trait, then it becomes challenging to make adequate judgments as to personality. Roberts concedes, however, that temporal consistency is definitely a key to the existence of personality traits.⁵⁵⁹

As to the meaning of personality traits, McCrae & Costa explain that unlike physical characteristics, personality traits are abstractions that cannot be directly measured and must instead be inferred from complex patterns of overt and covert behaviour.⁵⁶⁰ Hartmann draws inspiration from the works of psychology researchers such as McCrae & Costa, and states

1355-1385; see also D.C. Funder & C.R. Colvin, 'Explorations in Behavioural Consistency: Properties of Persons, Situations and Behaviours' (1991) 60 *Journal of Personality and Social Psychology* 773-794.

⁵⁵⁸ See Roberts, (note 555).

⁵⁵⁹ Ibid 140.

⁵⁶⁰ See R. McCrae & P.T. Costa Jr., 'Personality Trait Structure as a Human Universal' (1997) 52(5) *American Psychologist* 509-516 at 510.

that a personality trait is a latent attribute constituted of emotions, thoughts and behaviour.⁵⁶¹ Hartmann elaborates by indicating that personality traits are not focused on abilities such as intelligence quotient but are rather focused on the mental aspects of emotions, thoughts and actions as well as the reason behind these phenomena. He also argues that personality traits are latent attributes which may be hidden and not directly observable, and that personality is then discerned indirectly from observable actions. Hartmann also explains that personality traits may refer to the causal element of emotions, thoughts and behaviour, as well as the descriptive categories of these personality traits.⁵⁶² This means that personality is deciphered from outward behaviour which is a pointer to the existence of inward personality traits. Hartmann argues that the inward traits are the higher level of elements which inform specific personality traits, and the manifested concrete attitudes, actions, feelings etc. are the lower level observable elements which indicate the reality of personality traits. He further explains that whereas the manifest lower level elements may change over time and situation, the intrinsic higher level elements, which represent the actual personality trait, remain relatively stable over time and across situations.⁵⁶³

Hartmann argues further that the presence of a specific personality trait of a specific strength implies only a tendency for certain concrete attitudes, habits, acts and feelings but does not actually determine it or predict it with absolute certainty.⁵⁶⁴ If Hartmann argues that the intrinsic personality traits are latent and are indirectly discernible through the observance of actual behaviour, then it follows that actual behaviour which is a result of a specific personality trait will also be relatively stable over time and can be expected to occur more often than not. After all, it is these observable traits that are usually used to predict the existence of the intrinsic traits. It has been discussed earlier that situations could impact on behaviour. But, judgments as to personality traits are made based on the degree of occurrence of particular traits. Therefore, if an individual displayed particular attributes more often than not, then a near accurate judgment can be made as to his/her personality, even if the same individual displayed other attributes on some occasions. It would be problematic if opposite and contradictory traits occurred in exactly the same frequency because in that case accurate judgments might not be made as to personality dimensions. Ideally, one personality

⁵⁶¹ See Hartmann, (note 542) 151; See R.R McCrae & P.T. Costa, *Personality in Adulthood* (New York: The Guildford Press 1990).

⁵⁶² See Hartmann, (note 542) 152.

⁵⁶³ Ibid.

⁵⁶⁴ Ibid 153.

trait should occur more often than the other contradictory trait for it to be reasonable to presume that a certain personality dimension has been identified.

The issue here is that if different behaviours are indicative of a specific personality type, then the critical element is simply to understand that these different attributes are peculiar to a specific personality type and the issue would now rest on the frequency of occurrence as a parameter for measuring more accurately the existence of intrinsic personality traits and thereby making subsequent judgements as to personality types. In essence, personality is relatively stable over time, even though different situations may bring about different actions and outward behaviour, the judgment as to personality type, though not absolute as with nearly every other issue in human existence, is made based on the frequency of occurrence of specific traits which enables one presume relatively accurately that those traits would reoccur. It is, therefore, evident that where a judgment is made as to personality dimensions, one can expect that the likelihood of occurrence of those personality traits, the evidence of which resulted in the personality judgment, is very high. The actual behaviour which is observable is assumed to result from the existence of specific personality traits intrinsically, and both the outward behaviour and the intrinsic personality traits are indicative of the likely existence of the other.

From the foregoing definitions of personality and analysis of what the concept entails, it becomes apparent that personality is a major determinant factor in respect of outward behaviour.⁵⁶⁵ Therefore, behaviour can then be influenced by influencing personality choices. Corporate governance codes have not adequately taken this fact into account as there is no express requirement for particular personality dimensions in corporate governance⁵⁶⁶ Christensen notes that research and opinion have offered numerous reasons for unethical business behaviour, but little attempt is made to explain the reasons why people make business decisions and take actions which they know to be illegal or unethical.⁵⁶⁷ From the import of the concept of personality and its relationship to behaviour as discussed above,

⁵⁶⁵ See Allport, (note 549); see also Schultz & Schultz, (note 13), see also Hartmann, (note 542); see also McCrae & Costa, (note 560).

⁵⁶⁶ See the UK Corporate Governance Code, June 2010 for example in which the evaluation and recruitment provisions essentially focus on the skills, knowledge and experience of company directors. Those are important elements of governance no doubt, but the personality of company directors is equally important from the evidence that their personality contributes massively to their actual behaviour in corporate governance.

⁵⁶⁷ See S. Christensen, 'The Role of Law in Models of Ethical Behaviour' (2008) 77 *Journal of Business Ethics* 451-461 at 451.

it becomes evident that the personality of company directors is a significant factor in relation to the decisions and actions they undertake in respect of corporate governance.

5.3 THE FIVE-FACTOR MODEL OF PERSONALITY

The Five-Factor Model of personality is a trait based approach to the conceptualisation of personality, and it provides a platform for combining various approaches to personality assessment.⁵⁶⁸ In psychological research, there is almost a consensual view that the best representation of trait structure is provided by the Five-Factor Model.⁵⁶⁹ The Five-Factor Model originated from the theories of Fiske⁵⁷⁰ and subsequently Norman.⁵⁷¹ The model asserts that only five factors are required for the explanation of variations in personality as evidenced from questionnaires and descriptions of individual differences in human personality and behaviour.⁵⁷² As much as the model is widely accepted as representing a valid theory of personality, there are contrary arguments.⁵⁷³ However, the model does not claim to provide the answers to all possible aspects of personality, but rather deals with the important elements of the subject of personality.⁵⁷⁴ The Five-Factor Model of personality has proven robust against scrutinized empirical testing and has provided a valid model for understanding personality.⁵⁷⁵ The model provides the most widely used and empirically supported structure for describing individual differences in total behaviour.⁵⁷⁶ The five dimensions of personality traits are (i) Neuroticism versus Emotional Stability (ii) Extraversion (iii) Openness to Experience or Intellect, Imagination or Culture (iv) Agreeableness versus Antagonism (v) Conscientiousness or Will to Achieve.⁵⁷⁷ The NEO Personality Inventory (NEO-PI) and the NEO Personality Inventory Revised (NEO PI-R)

⁵⁶⁸ See Hartmann, (note 542) 150.

⁵⁶⁹ See J.M. Digman, 'Personality Structure: Emergence of the Five-Factor Model' (1990) 41 *Annual Review of Psychology* 417-440; see also McCrae & Costa Jr., (note 560) 509; see also S.V. Paunonen & M.C. Ashton, 'Big Five Factors and Facets and the Prediction of Behaviour' (2001) 81(3) *Journal of Personality and Social Psychology* 524-539.

⁵⁷⁰ See D.W. Fiske, 'Consistency of the Factorial Structures of Personality Rating from Different Sources' (1949) 44 *Journal of Abnormal and Social Psychology* 329-344.

⁵⁷¹ See W.T. Norman, 'Toward an Adequate Taxonomy of Personality Attributes: Replicated Factor Structure in Peer Nomination Personality Ratings' (1963) 66 *Journal of Abnormal and Social Psychology* 574-583.

⁵⁷² See Digman, McCrae & Costa, Paunonen & Ashton (note 569).

⁵⁷³ See J. Block, 'A Contrarian View of the Five-Factor Approach to Personality Description' (1995) 117 *Psychological Bulletin* 187-215; see also H.J. Eysenck, 'Four Ways Five Factors are not Basic' (1992) 13 *Personality and Individual Differences* 667-673.

⁵⁷⁴ See Hartmann, (note 542) 168.

⁵⁷⁵ Ibid.

⁵⁷⁶ See R. McCrae & O. John, 'An Introduction to the Five-Factor Model and Its Applications' (1992) 60 *Journal of Personality* 175-215.

⁵⁷⁷ See McCrae & Costa, (note 560) 509; see also Paunonen & Ashton, (note 569) 524.

were developed to operationalize the Five-Factor Model.⁵⁷⁸ The NEO PI-R questionnaire assesses 30 facets of personality traits, 6 for each factor.⁵⁷⁹ The Five-Factor Model is often used interchangeably with the “Big Five” dimensions of personality, but whereas the Five-Factor Model is mainly used in the non-lexical/casual disposition manner, the Big Five is used more in connection with the lexical/categorical view.⁵⁸⁰ Both concepts nevertheless posit that there are five super-traits of personality. There are other models which measure personality along the big five dimensions such as the Zuckerman-Kuhlman Personality Questionnaire (ZKPQ).⁵⁸¹ However, the NEO PI-R has become a standard of measurement for the Five-Factor Model.⁵⁸² According to the NEO PI-R as developed by Costa & McCrae, the following words are descriptive of the five personality dimensions:

NEUROTICISM: Anxious, Worrisome, Vulnerable, Pessimistic, Depressive, Bad-Tempered

EXTRAVERSION: Social, Friendly, Active, Thrill & Sensation Seeking, Optimistic, Assertive, Outgoing, Gregarious, Talkative

OPENNESS TO EXPERIENCE: Open to new impressions, Tolerant, Liberal, Flexible, Creative, Imaginative, In contact with their feelings, Novelty seeking

AGREEABLENESS: Altruistic, Modest, Trusting, Emphatic, Compliant, Polite

CONSCIENTIOUSNESS: Self-disciplined, Ambitious, Foresighted, Responsible, Orderly
Conscientious, Deliberate, Dutiful

Dimensions of personality refer to the patterns of co-variations of traits across individuals.⁵⁸³ This means that the above descriptions are dimensions and people can vary across them. Many personality traits are blends of two or more of the five dimensions, as for instance hostility can be adjudged as evidence of a high level of neuroticism or a low level of

⁵⁷⁸ See P.T. Costa & R.R. McCrae, *Revised NEO Personality Inventory (NEO PI-R) and NEO Five-Factor Inventory (NEO FFI) Professional Manual* (Odessa, FL: Psychological Assessment Resources Inc. 1992).

⁵⁷⁹ See McCrae & Costa, (note 560) 510.

⁵⁸⁰ See Hartmann, (note 542) 156.

⁵⁸¹ See J. Joireman & D.M. Kuhlman, ‘The Zuckerman-Kuhlman Personality Questionnaire: Origin, Development and Validity of a Measure to Assess an Alternative Five-Factor Model of Personality’ in R.M. Stelmack (ed.), *On the Psychobiology of Personality* (Oxford, UK: Elsevier 2004) 49-64.

⁵⁸² See Hartmann, (note 542) 157.

⁵⁸³ See McCrae & John, (note 576) 176.

agreeableness and shyness can be attributable to a combination of a high level of neuroticism and a low level of extraversion.⁵⁸⁴ Individuals can score low to high across the dimensions. Therefore, a combination of the dimensions would provide the outcome personality label. So, hypothetically, an individual can emerge as a person who is high in conscientiousness, medium (normal) in agreeableness and low in neuroticism.

Individuals can, therefore, be categorised into different personality dimensions and the Five-Factor Model has emerged as the most popular and widely accepted theory regarding this characterisation.⁵⁸⁵ The model is rooted in the use of descriptive words to identify the different personality traits and develop an understanding of the general personality of an individual. The NEO PI-R is a questionnaire which is used to assess and identify personality types and has proven to be a robust measure of the five personality dimensions.⁵⁸⁶ An analysis of the descriptive words used to identify the different personality dimensions would elicit the fact that the judgment as to personality is usually made based on actual behaviour. For instance, the neurotic personality is identified through actions such as anxiety and pessimism.⁵⁸⁷ Likewise, the conscientious personality is identified by his/her orderliness and self-discipline.⁵⁸⁸ Therefore, going by the Five-Factor Model, it is mostly in actual behaviour that personality dimensions are identifiable. These behaviours are described in words which are then interpreted as representing a particular dimension of personality. This description of behaviour which then points to specific personality traits reinforces the linkage between personality and behaviour, and emphasises the importance of making appropriate personality judgments in all cases where there is a desire to influence behaviour.⁵⁸⁹ In corporate governance, there have been several debates regarding ways of improving and influencing the behaviour of company directors as evidenced in the reports of committees discussed in the previous chapter.⁵⁹⁰ From an understanding of the relationship between personality and behaviour, it becomes evident that in order to influence the behaviour of the persons who are allowed to govern companies, one issue that is relevant and should be considered as vital is

⁵⁸⁴ Ibid 189.

⁵⁸⁵ See Digman, (note 569).

⁵⁸⁶ See Hartmann, (note 542) 157.

⁵⁸⁷ See McCrae & Costa, (note 560) 509; see also Paunonen & Ashton, (note 569) 524; see also Costa & McCrae, (note 578).

⁵⁸⁸ Ibid.

⁵⁸⁹ See McCrae & Costa, (note 560); see also Hartmann, (note 542).

⁵⁹⁰ See the Walker Review, (note 10), see also the Turner Review, (note 9); see also the ICSA Report, (note 10); see also the OECD Report, (note 402).

the choice of personalities in corporate governance.⁵⁹¹ If the aim is to have directors who are naturally likely to govern companies in the best possible manner, paying heed to the established rules and regulations enacted to ensure good governance, a good step to take would be an identification of the most appropriate personality types to achieve this aim, and then the recruitment of these appropriate personality types, as well as their retention.⁵⁹² In the case that inappropriate persons are recruited, then the associated risks should be identified and managed effectively.

5.4 IDENTIFICATION OF PERSONALITY DIMENSIONS

McCrae & Costa state that “.....unlike physical characteristics, personality traits are abstractions that cannot [usually] be directly measured [but] must instead be inferred from complex patterns of overt and covert behaviour.”⁵⁹³ In psychology, two methods have been developed for identifying personality traits, namely the lexical and the non-lexical methods.⁵⁹⁴ The lexical method is based on the theory that individual differences which are of most importance and relevance will eventually be incorporated into the language. This theory posits that the greater the significance of the individual difference, the greater the likelihood of expressing this difference in a single word. The lexical method was first theorized by Sir Francis Galton who collected more than 1000 words describing personality and then the method was further developed by psychologists such as Allport, Norman and Goldberg.⁵⁹⁵ The lexical method is essentially descriptive and some of its disadvantages are (i) language is used as a method of expression and does not meet strict scientific standards (ii) language varies between cultures and countries and even within same locations (iii) language is specific to particular subjects (iv) language and the use of language changes over time and raises the issue of whether personality traits change along with the language.⁵⁹⁶

⁵⁹¹ See Schultz & Schultz, (note 13) who argue that personality influences behaviour; see also Brody & Ehrlichmann, (note 554); see also Ryckman, (note 554); see also Phares, (note 550).

⁵⁹² For instance, in the Lehman Brothers failure, if the corporate officers had abided by the provisions of s 401 of the Sarbanes-Oxley Act, some of the problems which occurred would have been prevented, see the Lehman Report, (note 131) 3.

⁵⁹³ See McCrae & Costa, (note 560) 510.

⁵⁹⁴ See Hartmann, (note 542) 153.

⁵⁹⁵ See O.P. John, A. Angleitner & F. Ostendorf, ‘The Lexical Approach to Personality: A Historical Review of Trait Taxonomic Research’ (1988) 2 *European Journal of Personality* 171-203; see also D.W. Forrest, ‘Francis Galton (1822-1911)’ in R. Fuller (ed.), *Seven Pioneers of Psychology: Behaviour and Mind* (London & New York: Routledge 1995) 1-19.

⁵⁹⁶ Ibid, see also Hartmann, (note 542) 154.

The non-lexical method can be traced back to Jung and Murray.⁵⁹⁷ The method was then developed by Eysenck & Eysenck, Zuckerman and Costa & McCrae.⁵⁹⁸ The non-lexical method argues that all relevant personality traits can be identified either by imagination or by re-extraction of relevant personality traits from existing theories. Some disadvantages of this method are (i) the possibility that some personality traits are redundant or just philosophically relevant (as against being practically relevant, and so might invariably seem irrelevant) (ii) the uncertainty as to whether all relevant personality traits are indeed discovered and recorded in existing theories. At present, in psychological research, the two methods are combined to produce robust methods of describing and explaining personality traits.⁵⁹⁹ The distillation of the infinite number of personality traits based on language and re-extraction has led to the development of simple models, such as the Five-Factor Model, which is essentially a result of factor analysing data containing self-ratings or external ratings of personality traits. It was Fiske who first applied this method of analysis to the study of personality traits and discovered that the infinite number of personality traits could be distilled into five factors/super traits.⁶⁰⁰ This finding culminated in the development of the Big Five/Five-Factor Model, and the emergence of measurement models.

The fact that all factor solutions are indeterminate and that only factors with variance represented in the included variables can emerge means there could be an infinite number of models of measurement with different elements represented as variables.⁶⁰¹ The NEO PI-R and the ZKPQ have been used more frequently and analysed in literature, with the NEO PI-R proving more popular because of its synonymy with the Five-Factor Model, thereby creating a common metric for the big five dimensions.⁶⁰² One important point to note here is that the NEO PI-R is just one of the many potential models and is certainly not one which takes cognisance of all possible personality trait variables, especially as the model originates from the non-lexical approach to personality trait analysis.⁶⁰³ But, in order to identify personality traits, tests such as the NEO PI-R can be administered. The NEO PI-R uses the self-rating approach to personality tests and even though it is the common one, there are some reasons

⁵⁹⁷ See McCrae & John, (note 576) 185.

⁵⁹⁸ See H.J. Eysenck & S.B.G. Eysenck, *Eysenck Personality Scales (EPS Adult)* (London: Hodder & Stoughton 1991); see also Joireman & Kuhlman, (note 581); see also Costa & McCrae, (note 578).

⁵⁹⁹ See Hartmann, (note 542) 154-155.

⁶⁰⁰ See Digman, (note 569) 419.

⁶⁰¹ See Hartmann, (note 542) 156.

⁶⁰² Ibid 157.

⁶⁰³ Ibid.

why the results might be inaccurate. These include (i) the respondent not being self-aware and therefore answer the questions inaccurately (ii) careful/careless responses (iii) favourability/social desirability.⁶⁰⁴ These reasons emanate from the fact that the respondents are assessing themselves and may compromise the responses, knowingly or unknowingly. Despite these shortcomings, these tests are still relatively the most valid and best measuring models in existence.⁶⁰⁵

McCrae & Costa explain that human judges are needed in order to make inferences regarding personality, and they do so by responding to checklists or questionnaire statements which use natural language because personality traits are so central to human interactions and all important traits will be encoded in natural language.⁶⁰⁶ Therefore, an analysis of the trait language should show the personality structure. The NEO PI-R is a 240-item questionnaire with each of the five factors being represented by 6 specific traits or facets and responses are made on a 5 point scale from *strongly disagree* to *strongly agree*. The evidence of reliability, stability and validity of the factors are summarised in the NEO PI-R manual.⁶⁰⁷ Research conducted by McCrae & Costa also suggests that personality traits conform to the Five-Factor Model in various languages other than English in which the original model was developed.⁶⁰⁸ The application of the translated NEO PI-R in cultures and languages such as Chinese, German, Portuguese, Hebrew, Japanese, Korean and comparisons with the American English factor structure showed similar structures which leads to the probability that personality traits are universally similar.⁶⁰⁹ Therefore, the Five-Factor Model provides a good foundation for the understanding of personality in most parts of the world.⁶¹⁰ It also follows that the NEO PI-R can usually be relied upon as a good measurement of personality, regardless of race, language and culture.

The Five-Factor Model of personality dimensions is also evident in both self-reports and external ratings and this presents one of the strongest arguments in favour of the model.⁶¹¹

⁶⁰⁴ Ibid 159.

⁶⁰⁵ Ibid; see also McCrae & Costa, (note 560) 510; see also R.L. Piedmont, 'Validation of the NEO PI-R Observer Form for College Students: Towards a Paradigm for Studying Personality Development' (1994) 1 *Assessment* 259-268.

⁶⁰⁶ See McCrae & Costa, (note 560) 510-511.

⁶⁰⁷ See Costa & McCrae, (note 578).

⁶⁰⁸ See McCrae & Costa, (note 560).

⁶⁰⁹ Ibid.

⁶¹⁰ Ibid 515.

⁶¹¹ See McCrae & Costa, (note 134) 82.

As regards the short-comings associated with personality tests employing the self-report method, it has been suggested that observer-rating methods actually yield incremental validity over self-reports. In their research which was essentially focused on the Five-Factor Model and job performance indications, Oh, Wang & Mount state that self-report personality measures have been the most commonly used means of measurement but in consideration of the controversy relating to the low validity of personality measures in predicting job performance, alternatives to self-reports are suggested.⁶¹² They argue that it is important to demonstrate the robustness of findings by showing that results are the same across different methods of measurement and other strategies that may be employed include interviews, situational judgment tests and conditional reasoning measures.⁶¹³ Evidence also indicates that the big five personality dimensions can be inherited and remain stable over time.⁶¹⁴ Therefore, in order to elicit objective results, adopting varying methods of measuring personality would probably be useful. In corporate governance, an important factor would be the elucidation of personality traits which would be most appropriate for the effective governance of companies, and the development of sustainable means of identifying, recruiting and retaining such personalities in positions of governance. Researchers agree that using the Five-Factor Model as the basis for personality is a finding consistent enough to approach the status of law.⁶¹⁵ Although there are criticisms of the model, it remains the most widely accepted and robust approach for the explanation and identification of personality.⁶¹⁶ The model, therefore, enables a reasonably accurate determination of personality, and can be utilized in the assessment of personality traits.

⁶¹² See In-Sue Oh, G. Wang & M.K. Mount, 'Validity of Observer Ratings of the Five-Factor Model of Personality Traits: A Meta-Analysis' (2011) 96(4) *Journal of Applied Psychology* 762-773 at 762; (Regarding the controversy, some authors argue that the validity of personality measures in predicting job performance is very low whilst some other authors refute that claim, see R.E. Ployhart, 'Staffing in the 21st Century: New Challenges and Strategic Opportunities' (2006) 32 *Journal of Management* 868-897; see also In-Sue Oh & C.M. Berry, 'The Five-Factor Model of Personality and Managerial Performance: Validity Gains Through the Use of 360 degree Performance Ratings' (2009) 94 *Journal of Applied Psychology* 1498-1513).

⁶¹³ See Oh et al, *ibid* 763.

⁶¹⁴ See P.T. Costa & R.R. McCrae, 'Personality in Adulthood: A Six-Year Longitudinal Study of Self-Reports and Spouse Ratings on the NEO Personality Inventory' (1988) 54 *Journal of Personality and Social Psychology* 853-863; see also J.M. Digman, 'Five Robust Trait Dimensions: Development, Stability and Utility' (1989) 57 *Journal of Personality* 195-214.

⁶¹⁵ See J.M. Digman & J. Inuoye, 'Further Speculations of the Five Robust Factors of Personality' (1986) 50 *Journal of Personal and Social Psychology* 116-123.

⁶¹⁶ One common criticism is that the five-factor model does not explain "all" of human personality. See S.V. Paunonen & D.N. Jackson, 'What is Beyond the Big Five? Plenty!' (2000) 68 *Journal of Personality* 821-835. However, it has been argued that the five factor model gives a complete characterization of the person at a global level, and even though minute details can matter at certain times, the model offers the most stable explanation of personality dimensions at the basic and general level, see R.R. McCrae, P.T. Costa & C.M. Busch, 'Evaluating Comprehensiveness in Personality Systems: The California Q-Set and the Five-Factor Model' (1986) 54 *Journal of Personality* 430-446 at 444; see also Hartman, (note 542); see also McCrae & John, (note 576).

5.5 PERSONALITY TRAITS AND CORPORATE GOVERNANCE

One of the most prominent, simple and enduring definitions of corporate governance is that which emerged in the UK and which states that the term refers to the system through which companies are directed and controlled.⁶¹⁷ From this definition, one can decipher that governance of companies involves two facets, the leadership role and the performance role. This is because the use of the word “direct” connotes a leadership dimension to the act of corporate governance whilst the word “control” conjures up an image of taking actions which keep the company in the desired position. The “actions” which are undertaken to keep the company in a desired position can be viewed as the necessary performance required in engendering governance. Therefore, in elucidating the traits that are appropriate to the delivery of effective corporate governance, it is necessary to analyse the traits which have been adjudged as being correlated to leadership and performance. The five dimensions of personality will be discussed below in relation to the two facets of roles which make up corporate governance in accordance with the above definition.

5.5.1 LEADERSHIP ROLE

Judge, Bono, Ilies & Gerhardt in their meta-analysis on personality traits and leadership discuss the relationship between personality and leadership, and offer insightful views on the correlation between the big five personality traits and leadership.⁶¹⁸ They also state that there are two possible categories of leadership; leadership emergence and leadership effectiveness, and analyse the big five dimensions of personality in relation to these categories of leadership as follows:

- 1) Neuroticism – They refer to the works of Bass, Hill & Ritchie and Hogan et al, and state that evidence points to the fact that neuroticism is negatively related to leadership emergence and leadership effectiveness.⁶¹⁹ This means that individuals who are rated high in neuroticism would be ineffective leaders and are not likely to emerge as leaders in the first place.

⁶¹⁷ See the Cadbury Committee on Financial Aspects of Corporate Governance 1992, para 2.5.

⁶¹⁸ See T.A. Judge, J.E. Bono, R. Ilies & M.W. Gerhardt, ‘Personality and Leadership: A Qualitative and Quantitative Review’ (2002) 87(4) *Journal of Applied Psychology* 765-780.

⁶¹⁹ See B.M. Bass, *Bass and Stogdill’s Handbook of Leadership* (New York: Free Press 1990); see also N.C. Hill & J.B. Ritchie, ‘The Effect of Self-Esteem on Leadership and Achievement: A Paradigm and A Review’ (1977) 2 *Group and Organisation Studies* 491-503; see also R. Hogan, G.J. Curphy & J. Hogan, ‘What We Know About Leadership: Effectiveness and Personality’ (1994) 49 *American Psychologist* 493-504.

- 2) Extraversion - They refer to the works of researchers such as Gough, Hogan et al and Costa & McCrae, and conclude that extraversion is positively related to both leadership emergence and leadership effectiveness, but more strongly to leadership emergence. Gough had highlighted that adjectives used to describe leaders include active, assertive, and energetic, and these are the characteristics of extraverts.⁶²⁰ Hogan et al also noted that extraversion is positively related to leadership perception and Costa & McCrae noted that extraversion is strongly related to social leadership.⁶²¹
- 3) Openness to Experience - They refer to the works of Bass, Feist, McCrae & Costa, Stogdill, Yukl and Sosik et al, and state that open individuals are more likely to emerge as leaders and be effective leaders.⁶²² They also state that evidence from research shows that originality and creativity, both hallmarks of openness, are some of the most indicative skills required for leadership.
- 4) Agreeableness - They state that there is ambiguity as regards the relationship between agreeableness and leadership. Whereas being cooperative and demonstrating interpersonal sensitivity tends to be positively related to leadership (as shown by Bass and Zaccaro et al), agreeable personalities are usually modest and leaders are usually not excessively modest.⁶²³ Also, the necessity for affiliation appears to be negatively related to leadership.⁶²⁴
- 5) Conscientiousness - They state that initiative and persistence which are characteristic of conscientious persons have a positive correlation to leadership. They refer to the works of Kirkpatrick & Locke and Goldberg, and conclude that there is an expectation that conscientious individuals will be more effective leaders.⁶²⁵

⁶²⁰ See H.G. Gough, *Manual for the California Psychological Inventory* (Palo Alto, CA: Consulting Psychologists Press 1988).

⁶²¹ See Hogan et al, (note 619); see also Costa & McCrae, (note 614).

⁶²² See Bass, (note 619); see also G.J. Feist, 'A Meta-Analysis of personality in Scientific and Artistic Creativity' (1998) 2 *Personality and Social Psychology Bulletin* 290-309; see also McCrae & Costa, (note 560); see also R.M. Stogdill, 'Personal Factors Associated with Leadership: A Survey of the Literature' (1948) 25 *Journal of Psychology* 35-71; see also R.M. Stogdill, *Handbook of Leadership* (New York: Free Press 1974); see also G. Yukl, *Leadership in Organisations* (Upper Saddle River, NJ: Prentice Hall 1998); see also J.J. Sosik, S.S. Kahai & B.J. Avolio, 'Transformational Leadership and Dimensions of Creativity: Motivating Idea Generation in Computer-Mediated Groups' (1998) 11(2) *Creativity Research Journal* 111-121.

⁶²³ See Bass, (note 619); see also S.J. Zaccaro, R.J. Foti & D.A. Kenny, 'Self-Monitoring and Trait-Based Variance in Leadership: An Investigation of Leader flexibility Across Multiple Group Situations' (1991) 76 *Journal of Applied Psychology* 308-315.

⁶²⁴ See Yukl, (note 622).

⁶²⁵ See Kirkpatrick & Locke, (note 146); see also L.R. Goldberg, 'An Alternative "Description of Personality": The Big-Five Factor Structure' (1990) 59 *Journal of Personality and Social Psychology* 1216-1229.

In concluding their meta-analysis, Judge, Bono, Ilies & Gerhardt argue that the big-five personality dimensions are useful predictors of leadership ability, and they also state categorically that Extraversion, Conscientiousness and Openness to Experience are the strongest and most consistent positive correlates of leadership.⁶²⁶ In stating the limitations of their study, they also highlight the need for further research to elicit the exact reasons why these traits are better suited to leadership and they also indicate that situational factors may affect the validity of personality in predicting leadership ability.⁶²⁷ Consistent with the call for further research, O'Connor & Jackson⁶²⁸ indicate that there is a need to investigate personality and leadership correlations using alternative methods and they have explored a psychobiological approach to leadership using Cloninger's psychobiological model of personality.⁶²⁹ Biological models of personality tend to focus on the motivational bases of behaviour and are more explanatory as against the descriptive taxonomical approach of models such as the big-five.⁶³⁰ O'Connor & Jackson included personality scales from both the big-five model and the psychobiological model in their research in order to significantly improve their model of measurement. They found that Cloninger's psychobiological model of personality could explain some trait-based variance in leadership emergence and their results were also broadly consistent with the findings by Judge et al as the same three of the big-five personality dimensions were most significantly correlated with leadership ratings in at least one situation.⁶³¹ Again, in relation to situational factors, O'Connor & Jackson found their results consistent with the proposition by Zaccaro et al that trait-based variance is more important than situation-based variance in the prediction of leadership emergence.⁶³²

The indications from previous research that traits such as extraversion, conscientiousness and openness to experience are best suited and most indicative of positive leadership ability is no

⁶²⁶ See Judge et al, (note 618) 773.

⁶²⁷ Ibid 774.

⁶²⁸ See P.J. O'Connor & C.J. Jackson, 'Applying a Psychobiological Model of Personality to the Study of Leadership' (2010) 31(4) *Journal of Individual Differences* 185-197.

⁶²⁹ See C.R. Cloninger, 'A Systematic Method for Clinical Description and Classification of Personality Variants' (1987) 44 *Archives of General Psychiatry* 573-588; see also C.R. Cloninger, D.M. Svrakic & T.R. Przybeck, 'A Psychobiological Model of Temperament and Character' (1993) 50 *Archives of General Psychiatry* 975-990.

⁶³⁰ See O'Connor & Jackson, (note 628) 186.

⁶³¹ Ibid 193.

⁶³² Ibid; see also Zaccaro et al, (note 623). In general terms, it is argued that behaviour is attributable to personality more than it is to situational factors, see C. Engel, 'The Behaviour of Corporate Actors: How Much Can We Learn from the Experimental Literature' (2010) 6 *Journal of Institutional Economics* 445-475; see also Schultz & Schultz, (note 13) 195.

big surprise because the characteristics of individuals with those dimensions of personality is consistent with what is naturally required to achieve effective steering of a group. Considering the extraversion trait, an effective leader has to be assertive, active, energetic and zealous in order to inspire his/her constituency to achievement.⁶³³ Leadership is inherently more of an exercise in exerting positive influence over others and an individual who cannot inspire positivism is in a disadvantaged position as a leader and will probably prove ineffective as such. In relation to conscientiousness, an effective leader must be consistent and dependable so as to present a strong focal point for his/her followers. A leader who reneges on his/her duties cannot reasonably be expected to effectively steer his followers into a pattern of obedience and conformity.⁶³⁴ An effective leader should ideally possess characteristics such as self-discipline, responsibility and foresightedness.⁶³⁵ Individuals who have the personality dimension of “open to experience” will rightly emerge as effective leaders because imaginativeness and creativity are traits which are needed in order to harness the potentials inherent in leadership positions and maximise the usefulness of different kinds of followers.⁶³⁶ Neuroticism will have a negative relationship with leadership ability because an individual who is disposed to characteristics such as anger, pessimism and anxiety is unlikely to elicit respect and confidence as a leader.⁶³⁷

Judge et al indicate that there are ambiguities regarding the relationship between agreeableness and leadership, tending towards a conclusion that there is a negative correlation there.⁶³⁸ That result is surprising because ordinarily one would have assumed that an effective leader had to be one who could compromise in situations which required reasonable compromise and part of that clearly means taking on board alternative viewpoints and different opinions. Interpersonal sensitivity is certainly a characteristic of agreeable personality dimension and was illustrated as positively related to leadership.⁶³⁹ However, it appears that other facets of the agreeable personality such as modesty when exhibited in excessive proportions cause a negative correlation to leadership ability.⁶⁴⁰ It then appears justifiable to suggest that an agreeable personality may still be an effective leader if traits

⁶³³ See Gough, (note 620).

⁶³⁴ See Judge et al, (note 618); see also Goldberg, (note 625).

⁶³⁵ Ibid.

⁶³⁶ See Judge et al, (note 618); see also Stogdill, (note 622); see also Yukl, (note 622).

⁶³⁷ See Bass, (note 619); see also Hill & Ritchie, (note 619); see also Hogan et al, (note 619).

⁶³⁸ See Judge et al, (note 618).

⁶³⁹ See Zaccaro et al, (note 623); see also Bass, (note 619).

⁶⁴⁰ Ibid; see also Yukl, (note 622).

such as modesty are not exhibited excessively. In fact, O'Connor & Jackson in their study found that co-operativeness was a significant predictor of emergent leadership.⁶⁴¹ The definition of co-operativeness in that study is "the extent to which individuals identify with others, and understand the need to work with other people",⁶⁴² a definition which tends to lean more on the side of agreeableness, even though there is also an indication of extraversion inherent in it.

Therefore, considering this definition of co-operativeness and the results of the study, agreeableness may indeed be more positively related to leadership than was illustrated by Judge et al. Again, O'Connor & Jackson refer to arguments made by Cloninger et al that cooperativeness is correlated with age and they conclude that mature levels of cooperativeness are important for leadership.⁶⁴³ This "mature" level of cooperativeness can be likened to being reasonably modest, which may in addition to other agreeableness traits which are more positively related to leadership tweak the equation in favour of a more positive correlation between the personality trait of agreeableness and leadership ability. This is possible for instance where an individual who is agreeable and exhibits the trait of modesty realises that he/she also has to exert considerable influence over his/her followers and refrains from acting overly modest. Maturity might also prevent affiliations, another facet of agreeableness which is negatively correlated with leadership,⁶⁴⁴ because a mature leader should invariably possess a better understanding of the need to appear neutral in order to remain relevant to all necessary constituencies and inspire relatively equal respect and confidence amongst all followers.

It is evident from the literature and studies analysed above that certain personality dimensions are better suited to leadership roles. In corporate governance, therefore, if effective leadership is desired, then it becomes important to take cognisance of these elements and develop mechanisms which ensure that the persons recruited into positions with responsibility for corporate governance are those who can be reasonably expected to undertake effective leadership roles in the companies they govern. Where individuals who are not appropriately suited to leadership roles are involved in the leadership of companies, it could contribute to ineffectiveness in the performance of those roles. The analysis of

⁶⁴¹ See O'Connor & Jackson, (note 628) 193.

⁶⁴² Ibid 188.

⁶⁴³ Ibid 193; see also Cloninger et al, (note 629).

⁶⁴⁴ See Yukl, (note 622).

personality dimensions also shows that personality seldom changes and is actually stable over time, and so we can expect, for instance, that a neurotic person who becomes a company director would exhibit neurotic tendencies more often than not in clear inconsistency with the tenets of good leadership. There is more of a lower than a higher possibility that such a person would become an appropriate leader at any point in time. The personality risk inherent in such a situation should be identified and managed.

5.5.2 PERFORMANCE ROLE

There has also been considerable research on the correlation between personality dimensions and job performance.⁶⁴⁵ The original work done by Barrick & Mount and the work of other researchers such as Tett, Jackson & Rothstein and Robertson & Kinder provides evidence that personality dimensions do have an impact on job performance.⁶⁴⁶ In subsequent years, the works of Mount & Barrick, Salgado and Behling led to conclusions that conscientiousness is a valid predictor of job performance and represents the primary personality dimension for use in personnel selection.⁶⁴⁷ In their meta-analysis, Hurtz & Donovan pointed out methodological and statistical issues with past reviews on personality and job performance, and sought to provide a confirmatory meta-analysis of the relations between the big five and job performance by including only scales that were explicitly designed to measure the big five personality dimensions.⁶⁴⁸ Their overall results were highly consistent with the original work of Barrick & Mount because they found that conscientiousness had the highest validity amongst the big five dimensions of personality for overall job performance. They also found that emotional stability as against neuroticism; extraversion, agreeableness and openness to experience had some validity depending on the job criterion.

⁶⁴⁵ See G.M. Hurtz & J.J. Donovan, 'Personality and Job Performance: The Big Five Revisited' (2000) 85(6) *Journal of Applied Psychology* 869-879.

⁶⁴⁶ See Barrick & Mount, (note 134); see also Tett, Jackson & Rothstein, (note 146); see also I.T. Robertson & A. Kinder, 'Personality and Job Competencies: The Criterion-Related Validity of Some Personality Variables' (1993) 66 *Journal of Occupational and Organisational Psychology* 226-244; see also C.J. Thoresen, J.C. Bradley, P.D. Bliese & J.D. Thoresen, 'The Big Five Personality Traits and Individual Job Performance Growth Trajectories in Maintenance and Transitional Job Stages' (2004) 89(5) *Journal of Applied Psychology* 835-853.

⁶⁴⁷ See Hurtz & Donovan, (note 645) 869; see also M.K. Mount & M.R. Barrick, 'The Big Five Personality Dimensions: Implications for Research and Practice in Human Resources Management' in K.M. Rowland & G. Ferris (eds.), *Research in Personnel and Human Resources Management*, Vol 13 (Greenwich, CT: JAI Press 1995) 153-200; see also J.F. Salgado, 'The Five Factor Model of Personality and Job Performance in the European Community' (1997) 82 *Journal of Applied Psychology* 30-43; see also O. Behling, 'Employee Selection: Will Intelligence and Conscientiousness do the job?' (1998) 12 *Academy of Management Executive* 77-86.

⁶⁴⁸ See Hurtz & Donovan, (note 645) 875.

Hurtz & Donovan note that conscientiousness does appear to have the strongest relation to overall job performance, and anti-neuroticism shows a consistent impact on job performance.⁶⁴⁹ According to them, agreeableness gains importance for jobs that require interpersonal reactions and extraversion does the same for jobs that have sales and managerial elements. They also note that in jobs that have a customer service element, openness to experience becomes a valid predictor of performance. Hurtz & Donovan state that these theoretically meaningful relations are low in magnitude at the broad dimension level of the big five and suggest that the magnitude of these correlations might be enhanced if the most relevant specific facets of these broad personality dimensions are specified.⁶⁵⁰ Again, they suggest a combination of selected facets of the correlated personality dimensions in future research in order to enhance and optimize the prediction of job performance especially across different types of job criteria. The importance of adopting alternative methods of measurement such as external and observer ratings, as against using just self-reports, was also highlighted. In discussing the limitations of their study, they state that so little research of this nature has been done using managers and clarification of the impact of the big five on this category of persons would be very beneficial for selection research and practice. In summary, Hurtz & Donovan highlight that the conscientiousness personality dimension has a moderate impact on performance, but its validity appears stable and generalizable across occupations and criteria.⁶⁵¹

In their original study, Barrick & Mount concluded that the validity of personality as a predictor of job performance was quite low, but they conceded that at the time of their study there was no well accepted taxonomy for classifying personality traits.⁶⁵² Hurtz & Donovan took cognisance of this limitation in their own meta-analysis, but ended up with a similar result.⁶⁵³ Morgeson et al in their review of literature relating to personality and job performance also highlighted that the validity of personality measures in predicting job performance is so low that the use of self-report personality tests in personnel selection should be reconsidered.⁶⁵⁴ More recently and in response to this concern, Oh et al in their meta-analysis drew a conclusion to the effect that the validity of the big-five in predicting

⁶⁴⁹ Ibid 876.

⁶⁵⁰ Ibid 877.

⁶⁵¹ Ibid.

⁶⁵² See Barrick & Mount, (note 134) 1-2.

⁶⁵³ See Hurtz & Donovan, (note 645).

⁶⁵⁴ See F.P. Morgeson, M.A. Campion, R.L. Dipboye, J.R. Hollenbeck, K. Murphy & N. Schmitt, 'Reconsidering the Use of Personality Tests in Personnel Selection Contexts' (2007) 60 *Personnel Psychology* 683-729.

overall job performance is higher than previous research had shown and their results reinforce the importance of separating the validity of personality traits in predicting performance from the method of measurement of the traits.⁶⁵⁵ Oh et al suggest explanations for the low validity of self-report such as individuals faking their responses. They refer to evidence that personality assessments made by well-acquainted observers can provide equally accurate information about an individual.⁶⁵⁶ Oh et al point out a distinction between self-reports and observer ratings in the sense that self-reports assess the internal dynamics that shape the behaviour of an individual, whereas observer ratings capture the reputation of an individual.⁶⁵⁷ Interestingly, they also state that “because reputations typically are based on the individual’s past performance, and because past performance is a good predictor of future performance, reputations are likely to be more predictive of behaviour in work settings than the internal dynamics of one’s personality”.⁶⁵⁸ However, they also point out some obvious limitations of observer ratings such as the fact that observers have limited opportunity to observe a target individual’s behaviour across times and situations, and some personality traits are indeed private to the target individual and would not be easily observable externally. In conclusion, Oh et al state that observer ratings have substantial incremental validity over self-reports and consistent with previous research, they also found that conscientiousness has the highest validity in predicting overall job performance.⁶⁵⁹

5.6 PERSONALITY TRAITS AND SPECIFIC JOB PERFORMANCE

From the foregoing analysis of research and literature, some key concepts emerge. Firstly, there is a definite, albeit a moderate, correlation between personality and job performance. More recent research has shown increased validity in this respect in cases where observer ratings are utilized.⁶⁶⁰ Secondly, all of the research undertaken highlights the prominence of the conscientiousness dimension of personality as the highest, strongest and most stable predictor of job performance. Hurtz & Donovan indicate that other dimensions such as anti-neuroticism, agreeableness and openness to experience also have some validity depending on the job criteria with conscientiousness and emotional stability (which is essentially anti-

⁶⁵⁵ See Oh et al, (note 612).

⁶⁵⁶ See D.W. Kolar, D.C. Funder & C.R. Colvin, ‘Comparing the Accuracy of Personality Judgments by the Self and Knowledgeable Others’ (1996) 64 *Journal of Personality* 311-337.

⁶⁵⁷ See Oh et al, (note 612) 764.

⁶⁵⁸ Ibid.

⁶⁵⁹ Ibid 771.

⁶⁶⁰ Ibid. See also Thoresen et al, (note 646).

neuroticism) showing the most stable influence on performance across most job criteria.⁶⁶¹ Thirdly, some of the researchers reiterate the place of general cognitive ability as the single best predictor of overall job performance, but they still allude to the fact that personality dimensions have an impact on job performance.⁶⁶² Fourthly, there are concerns about the low validity of the correlations between personality and job performance, but subsequent research has also illustrated that the problems might lie in the methods of measurement, and so adopting self-report methods in conjunction with observer ratings or external rating would increase the validity of the results in substantial measures.⁶⁶³ Based on the arguments above, it is evident that personality has an impact on job performance.

Regardless of the controversy surrounding the exact level of influence exerted, in consideration of the risks involved in employing persons with personalities which might not be suited to effective job performance, and mindful of the fact that risks which are adjudged low might actually have high impact (as evident in risk analysis and assessment measures), it becomes important to take cognisance of personality dimensions in recruiting company directors into corporate governance. Hertz & Donovan noted in their work that persons of managerial level had not been used in most of the published research on the subject of personality and job performance,⁶⁶⁴ but the results which are obtained from workers in other job criteria can generally be extended to managers because they are also human beings with personality dimensions which are assessable along similar lines as other workers. The relationship between personality and job performance would become more or less significant depending on the particular job role, and the personality traits which exert a positive or negative influence on that role.⁶⁶⁵ Again, the fact that managers are seldom used in personality researches also indicates that personality issues in job performance are rarely directed at high level officers but mostly on lower level employees. But, lower level employees usually take instructions from high level officers such as managers and the

⁶⁶¹ See Hertz & Donovan, (note 645) 876.

⁶⁶² Ibid; see also Oh et al, (note 612) 769; see also J.R. Graham, C.R. Harvey & M. Puri, 'Managerial Attitudes and Corporate Actions' (2010) <http://ssrn.com/abstract=1432641> (accessed 15th June 2012) where it is argued that personality traits certainly affect corporate actions; see also D.V. Day & S.B. Silverman, 'Personality and Job Performance: Evidence of Incremental Validity' (1989) 42(1) *Personnel Psychology* 25-36 which indicates that some personality scales are significantly related to important aspects of job performance even where cognitive ability is taken into account and that cognitive ability tests are more predictive of job performance when used in conjunction with personality tests.

⁶⁶³ See Oh et al, (note 612).

⁶⁶⁴ See Hertz & Donovan, (note 645) 877.

⁶⁶⁵ Ibid 876.

possibility is higher that they would ordinarily obey the instructions emanating from the managers because the managers are in a position of authority.

If managers are not persons with the potential to issue appropriate instructions, then the instructions they project could be reflective of their personality and so the employees may take actions that are inappropriate based on instructions that are inappropriate. The fact that some research has shown that trait-based variance is generally more important than situation-based variance also supports the argument that a manager's personality and its influence on job performance may not necessarily differ in a situation where he/she is not a manager.⁶⁶⁶ That means that a neurotic personality is likely to exhibit the same traits of neuroticism in both lower level employee roles as well as in managerial roles. Again, the conscientiousness personality dimension was particularly shown to be valid and stable across different job criteria.⁶⁶⁷ This is an indication that the conscientiousness personality traits are such that are compatible with effectiveness in job performance roles involving varying aspects. The important element would undoubtedly be to adopt robust means of measuring these personality dimensions in order to arrive at accurate and substantial results in relation to correlations between personality and job performance.

Personality tests based on the work of psychology researchers have been used in employee selection for many years.⁶⁶⁸ Company directors may not always be grouped as employees in that sense of the word and they are more likely than not the group of people who authorise the conduct of personality tests on other lower level employees.⁶⁶⁹ It is doubtful whether they actually subject themselves to the same tests as other employees, especially considering as Hurtz & Donovan pointed out that they have not even been the subject of personality researches in most cases. In reality, company management activities could also be delegated to the management team by the company directors, and so it is a valid argument that corporate governance mechanisms should be extended to the management personnel who are involved in the day to day operations of the company and from whom other employees take direct instructions. It is quite possible that some companies evaluate the personality of their management employees at the point of recruitment, as they might do all other employees, but

⁶⁶⁶ See Schultz & Schultz, (note 13); see also O'Connor & Jackson, (note 628); see also Zaccaro et al, (note 623).

⁶⁶⁷ See Hurtz & Donovan, (note 645); see also Mount & Barrick, (note 647); see also Behling, (note 647).

⁶⁶⁸ See Hurtz & Donovan, Ibid 869.

⁶⁶⁹ Some directors such as the CEO may be employees as well. Other directors may simply have a directorship with the company.

it is more doubtful that the same process is undertaken for company directors. Again, the management team usually act upon the instructions of company directors, a situation which underscores the necessity to pay more attention to the personality of company directors.

The UK Corporate Governance Code does not make recommendations in relation to personality assessments and the recruitment of company directors has had a tradition of being undertaken on the basis of the “old boys club” syndrome.⁶⁷⁰ Therefore, except in cases where internal company policies require a personality check, or a company in the UK which is subject to the authority of the financial services regulator which conducts some level of personality checks under its approved person’s regime,⁶⁷¹ there is a risk that a company could recruit directors whose personalities are largely unchecked and unknown. This is certainly a personality risk for the corporate governance process considering that there is a correlation and an impact of personality on both leadership and job performance. Recruiting persons who have the potential to contribute to corporate failures as a result of their personalities increases risks in corporate governance because such persons cannot be reasonably expected to exhibit appropriate leadership and performance behaviour which engenders a higher expectation of corporate success. It is therefore useful to identify personality risks on the part of company directors by applying personality assessments alongside other considerations which might be useful for determining the appropriateness of a director for that role.

One relevant question that emerges from the analysis above is what kinds of personality dimensions are best suited to corporate governance? It is evident that certain personality types are best suited to leadership roles and these are extraversion, conscientiousness and openness to experience.⁶⁷² It is also obvious that as regards job performance, conscientious and anti-neurotic personalities are the strongest and most stable dimensions.⁶⁷³ In fact, it has been argued that in no case would conscientiousness and agreeableness become a liability in an organisation because those personality dimensions are organisational virtues.⁶⁷⁴ It means, therefore, that a combination of these positively correlated personality types would be best suited to corporate governance. However, it may not always be possible to obtain the most

⁶⁷⁰ Sir Adrian Cadbury noted that this syndrome is like a virus which is ingrained in the culture of company management in the UK and is not likely to abate or disappear in the nearest future because old habits die hard. See Cadbury, (note 225); see also Dulewicz & Herbert, (note 224).

⁶⁷¹ See The Financial Services Authority Approved Persons Regime for UK financial services sector.

⁶⁷² See Judge et al, (note 618).

⁶⁷³ See Hurtz & Donovan, (note 645).

⁶⁷⁴ See D.J. Moberg, ‘The Big Five and Organisational Virtue’ (1999) 9(2) *Business Ethics Quarterly* 245-272.

appropriate combination of these personality types. So, it becomes important especially for increased effectiveness and practicality to decipher which dimensions of personality are so vital for governance that they should always be present if a reasonable expectation can be made as regards effective corporate governance. In this regard, an analysis of the common denominator of appropriate personality dimension as it relates to both governance roles of leadership and performance is relevant and that personality dimension is conscientiousness.

The correlation of various personality types to governance roles has already been discussed, and the impact of each of them has been analysed. Therefore, even though there is a positive relationship between some other personality dimensions and the governance roles, the conscientiousness dimension is singled out here as the most important dimension for the reason that a conscientious person would be an appropriate leader as well as an appropriate performer on the job. For reasons of efficiency at least, if there is one personality dimension which if present in corporate governance would reasonably create increased assurances of effective governance and contribute towards mitigating personality risks, that personality dimension would be conscientiousness. Part of mitigating personality risks would involve ensuring the presence of persons with the potential to perform effectively in corporate governance. One of the first steps in this direction is the identification of these persons. The conscientious personality is one essential personality dimension which is suited to all the facets of corporate governance.

5.7 CONSCIENTIOUSNESS

This is the fifth domain of personality dimension in the NEO PI-R test and assesses the degree of organisation, persistence, control and motivation in goal directed behaviour. A high score in this regard identifies individuals who tend to be organised, reliable, hard-working, self-directed, punctual, scrupulous, ambitious and persevering. According to the Five-Factor Model, the traits or facets that define the conscientiousness dimension of personality are as follows:

- 1) Competence- Belief in own self efficacy.
- 2) Order- Personal Organisation.
- 3) Dutifulness- Emphasis placed on importance of fulfilling obligations.
- 4) Achievement Striving- Need for personal achievement and sense of direction.
- 5) Self-Discipline- Capacity to begin tasks and follow through to completion despite boredom or distractions.

6) Deliberation- Tendency to think things through before acting or speaking.

An analysis of the import of these traits illustrates why the conscientiousness dimension of personality has proven to be a valid and stable predictor of both leadership and performance roles.⁶⁷⁵ The other positive personality dimensions are of importance no doubt, but, as regards goal directed tasks such as corporate governance, the most vital personality dimension would be conscientiousness.⁶⁷⁶ More importantly, as there is evidence to support the fact that some major corporate failures occurred as a result of disobedience to established principles and regulations,⁶⁷⁷ and conscientious personalities are more likely than not to be dutiful by obeying principles and regulations, having conscientious personalities involved the governance of companies would increase the likelihood of obedience to principles and regulations, thereby preventing the kind of corporate failures that can occur for reasons of disobedience. Examples of corporate failures analysed in the previous chapter highlight this thread of disobeying recommendations and regulations. Hartman, in analysing the practical perspectives of the trait theory, states that models like the five-factor model should help us anticipate events and perhaps intervene.⁶⁷⁸ In a summary of results obtained from various studies and presented in a tabulated form, he highlights the predominance and recurrence of conscientiousness in job related functions, and states that the knowledge obtained through personality assessment can help to shape and change lives for the better, both for the individual and for society in general.⁶⁷⁹ This is certainly true and relevant in the area of corporate governance.

The knowledge that certain personality dimensions have the potential to be better suited to governance if utilised appropriately in selecting, recruiting and retaining company directors would help in creating effective corporate governance and preventing corporate failures. In particular, the knowledge that conscientious personalities are most likely to succeed at leadership and job performance should inform the decisions regarding the recruitment of company directors, alongside other considerations such as cognitive ability. It has been

⁶⁷⁵ See Judge et al, (note 618); see also Hertz & Donovan, (note 645).

⁶⁷⁶ See Hertz & Donovan, *ibid*.

⁶⁷⁷ See for instance the BCCI, Enron and Lehman Brothers failure discussed in chapter four.

⁶⁷⁸ See Hartmann, (note 542) 166.

⁶⁷⁹ *Ibid*, see the table at 166-167; see also H. Grove & E. Basilico, 'Major Financial Reporting Frauds of the 21st Century: Corporate Governance and Risk Lessons Learned' (2011) 3(2) *Journal of Forensic and Investigative Accounting* 191-226 at 203 where it is stated that targeted executive selection is essential and appropriate personality is one of the four competences proposed.

asserted that “it is quite presumable that high values of conscientiousness lead the most vivid corporate decision makers to centralize structures and decisions, as well as to assume proactive behaviours within their competitive environment.”⁶⁸⁰ It is certainly a risk to the entire corporate governance process to have personalities who are not conscientious involved in corporate governance because as much as some of the other personality dimensions are also positively correlated to leadership and performance, conscientiousness appears to be the most vital personality dimension due to the goal oriented nature of corporate governance.

In the management of personality risks, ensuring that individuals who are conscientious are recruited and retained will help ensure the overall effectiveness of the corporate governance system because that personality dimension is valid across both leadership and performance roles.⁶⁸¹ Individuals may possess personality traits which embrace the five domains of personality, but (as analysed in earlier sections of this chapter), the salient issue is the frequency of occurrence of particular traits as a determinant of personality dimension, and the important factor in this case is that individuals who possess higher levels of conscientiousness would be suited to corporate governance.⁶⁸² Again, researchers such as Paunonen & Ashton have argued that it is important to narrow down the particular facet or trait within a personality domain which actually contributed to the prediction of specific behaviours.⁶⁸³ For instance, if a conscientious individual obeys principles and regulations, then it would be narrowed down to the dutifulness facet or trait. Christopher, Zabel & Jones in their work on conscientiousness and work ethic ideology highlight that amongst the 6 facets of conscientiousness, dutifulness and achievement striving were the two most consistent predictors of seven dimensions of work ethic ideology.⁶⁸⁴ Achievement striving predicted the belief that hard work yields desirable outcomes, the centrality of work, the avoidance of wasting time and the delay of gratification. Dutifulness on the other hand predicted self-reliance and morality/ethics.⁶⁸⁵ This knowledge would be particularly helpful in cases where specific behavioural tendencies are desired and more accurate judgments can be made as to predictions of behaviour.

⁶⁸⁰ See G. Abatecola, G. Mandarelli & S. Poggesi, ‘The Personality Factor: How Top Management Teams Make Decisions-A Literature Review’ (29th October 2011), *Journal of Management and Governance*, DOI 10/1007/s10997-011-9189-y (Online First publication) 20.

⁶⁸¹ See Judge et al, (note 618); see also Hurtz & Donovan, (note 645).

⁶⁸² This is based on the validity of the conscientiousness personality across the different roles involved in corporate governance.

⁶⁸³ See Paunonen & Ashton, (note 569) 532.

⁶⁸⁴ See Christopher et al, (note 380).

⁶⁸⁵ Ibid 196.

The UK Corporate Governance Code consists essentially of principles and recommendations which operate on a voluntary basis. Based on the spirit of free enterprise, entrepreneurs, company directors and managers have preferred voluntary codes as against statutory intervention in the running of businesses.⁶⁸⁶ It is therefore important to have company directors who have the tendency to obey these voluntary corporate governance principles and recommendations as this act of obedience is clearly one of the foundations of a successful and effective governance regime.⁶⁸⁷ Even in cases where statutory regulations exist, it is important to ensure that company directors have a sense of obligation and are able to abide by these regulations. As was argued earlier in relation to internal controls, the fact that rules can be circumvented is a risk to an entire governance regime. Taking cognisance of this, it becomes evident that the most important facet of conscientiousness as it relates to corporate governance would be dutifulness. An individual may have many varying traits which may or may not be positively correlated to corporate governance, but, if corporate governance mechanisms have already been established in the form of governance codes and regulations, and this individual is a dutiful person who is likely to obey the code and regulations, then effective corporate governance could still occur.⁶⁸⁸ In other words, the action and resolve of obedience to established corporate governance principles and compliance with regulations will help ensure the successful governance of a company by individuals who are dutiful even though the same individuals may have other personality facets which are not necessarily positively correlated to corporate governance.

In the imperfect world, where people may not necessarily possess all the required personality traits which are adjudged to be most conducive to corporate governance, ensuring that people who are allowed into the corporate governance system possess at least the most vital personality trait of dutifulness becomes a critical issue. This way, there is an increased opportunity to have differing calibres of persons in governance who would bring on board their varying strengths to the process, but the common denominator would be that most vital

⁶⁸⁶ See Du Plessis, (note 50).

⁶⁸⁷ See Christopher et al, (note 380).

⁶⁸⁸ This is because that individual will abide by the established codes and regulations which aim to secure effective corporate governance. See the Revised Turnbull Guidance, (note 170) which provides that internal control rules are aimed at safeguarding the company from risks in order to help achieve corporate objectives. See also the UK Corporate Governance Code 2010 (p 3) which provides that the function of the code is to help boards of directors discharge their duties in the best interest of their companies, and this connotes effective governance.

personality trait which is determined as a constant in order to ensure better governance. For instance, if there is an extrovert personality on the board of directors of a company, as well as an agreeable personality, these two different personalities may contribute to the management of the company in different ways due to their personality dimensions. Whereas the extrovert personality would most likely be able to interact socially with the necessary constituencies in order to get things done, the agreeable person would also be most likely to engage in necessary compromises which would be required to move the company ahead. As long as both personalities are able to obey and abide by established corporate governance principles and regulations, it becomes more likely that effective governance would be achieved and corporate failures could be prevented. In fact, Witt argues that there is a significant interaction between extraversion and conscientiousness to the effect that the relationship between extraversion and performance was positive in cases where there was also a high level of conscientiousness but became negative in cases where the individual was low in conscientiousness.⁶⁸⁹ Therefore, an individual who is conscientious and particularly possesses the dutiful trait would have adequate potentials to undertake effective corporate governance. In the case that a company director does not possess this trait, there is an increased personality risk in the corporate governance process. In any case in which persons with the potential to behave inappropriately are recruited into the governance process, there should be an awareness of the risks associated with their personalities and it becomes important that adequate measures are taken to manage these risks.

Trevino has argued for a person-situation interactionism model, which essentially posits that one's actual behaviour, particularly as it relates to ethics, would be determined by two factors: the individual (personality) and the situation (job context, organisational structure etc.).⁶⁹⁰ This is true because the interactions which occur are essentially between personal and situational variables. However, even though situational variables are relevant, the personality variables are more stable and indicative of outcomes in behaviour.⁶⁹¹ In corporate governance, if principles and regulations have already been established to take care of varying anticipated situations, and certain actions have been mandated in response to those situations, then the other element which happens to be the most vital one is the actual ability of company directors to respond to the situation by adopting or complying with the required

⁶⁸⁹ See L.A. Witt, 'The Interactive Effects of Extraversion and Conscientiousness on Performance' (2002) 28 *Journal of Management* 835-851.

⁶⁹⁰ See Trevino, (note 134).

⁶⁹¹ See Schultz & Schultz, (note 13); see also Phares, (note 550).

action as mandated. This most vital element is determined by the personality variable. So, for example, if the corporate governance regulations mandate that systemic risk should be managed in a particular way, using particular processes, the pertinent issue becomes whether the directors would obey these regulations and actually manage systemic risk in the particular way that has already been mandated. The management of the systemic risk is the situation, but the eventual outcome in relation to that situation is determined by whether the directors are dutiful and manage the systemic risk as prescribed.

Most situational issues in business might already be catered for because with experience, most situations are planned and systems put in place to regulate outcomes. There is no doubt that there may be unplanned and unforeseen situations at some points, however, the presence of persons with the potential to behave appropriately on corporate boards should engender more effective and positive responses to even unplanned and unforeseen situations based on the fact that they would have a better sense of duty towards achieving corporate success and this should inform their decisions and actions at all times. Recruiting company directors who are most likely to abide by corporate governance principles and regulations regardless of the situation at hand is one means of creating effective corporate governance and helping to promote the prevention of corporate failures. Recognising and managing the personality risks which accrue from having directors who have the potential to disobey corporate governance principles and regulations is also another means of engendering effective corporate governance, more so because corporate governance is an exercise in risk management.

In relation to the influence of appropriate individual personality dimensions on collective personality and performance, Hofmann & Jones note that collective personalities emerge and develop as individuals come together and begin to interact.⁶⁹² They argue that leadership is one factor which is capable of influencing collective personality and they cite the example of a leader who consistently emphasizes creativity as being able to engender collective routines

⁶⁹² See D.A. Hofmann & L.M. Jones, 'Leadership, Collective Personality and Performance' (2005) 90(3) *Journal of Applied Psychology* 509-522; see also D.A. Harrison, K.H. Price, J.H. Gavin & A.T. Florey, 'Time, Teams and Task Performance: Changing Effects of Surface and Deep-level Diversity on Group Functioning' (2002) 45 *Academy of Management Journal* 1029-1045.

which would be consistent with the openness to experience personality dimension.⁶⁹³ Likewise, one can then expect that in corporate governance, a leader who consistently emphasizes dutifulness would eventually engender the same sense of dutifulness in the organisation as a collective group. It has been argued that personality has more direct and powerful effects on group processes than other composition variables such as age, race, gender and information distribution.⁶⁹⁴ This is all the more reason why it is important to ensure that the company directors who are at the helm of affairs in companies are conscientious and dutiful. For the reason that these persons are also in leadership roles, they are better able to influence others through to the bottom of the corporate ladder. There can then be a reasonable expectation that corporate governance would be improved collectively.⁶⁹⁵

Despite the existence of corporate governance codes and corporate law which are promulgated to guide the behaviour of company directors, examples of corporate failures as discussed in the previous chapter illustrate that directors continue to fail to obey the tenets of corporate governance codes and recommendations in statutory regulations. The pertinent question is whether every kind of individual would actually have the natural ability to obey these corporate governance principles and statutory regulations? An analysis of the literature on personality dimensions would indicate the answer as negative. Personality risk is therefore introduced into the corporate governance process by the presence of individuals who are not accustomed to obedience by virtue of their personality, and so, cannot therefore be reasonably expected or guaranteed to always obey corporate governance principles and

⁶⁹³ See Hofmann & Jones, *ibid* 510; see also G.L. Stewart, 'Toward an Understanding of the Multilevel Role of Personality in Teams' in M.R. Barrick & A.M. Ryan (eds.), *Personality and Work: Reconsidering the Role of Personality in Organisations* (San Francisco: Jossey-Bass 2003) 183-204.

⁶⁹⁴ See L.M. Moynihan & R.S. Peterson, 'A Contingent Configuration Approach to Understanding the Role of Personality in Organisational Groups' in B. Staw & R.I. Sutton (eds.), *Research in Organisational Behaviour*, Vol 23 (Greenwich, CT: JAI Press 2001) 327-378 at 328.

⁶⁹⁵ See Hofmann & Jones, (note 692); see also Stewart, (note 693); see also Moynihan & Peterson, (note 694) where it is argued that high average levels of conscientiousness and agreeableness created positive effects on group processes and outcomes. However, high levels of conscientiousness could also be a problematic issue in corporate governance as there may be downsides to it, see I.L. Janis, *Victims of Groupthink* (Boston: Houghton Mifflin Company 1972) where it is explained that the danger of "groupthink" can dominate an organisation in cases where persons are conscientious and prone to conformity, and this can lead to a failure to critically appraise other options and consequently a reluctance to challenge established principles, rules and regulation which can in turn lead to reduces capacity for initiative and innovation. So, unquestioning adherence to procedures can result in negativity at certain times and prevent the company from responding to challenges in a flexible manner. Therefore, a balance has to be achieved in order to engender effectiveness as well as foster adequate levels of initiative, independence and innovation in companies.

statutory regulations. Considering the impact of corporate failures on companies and society as a whole, it becomes important to give serious consideration to these issues and develop mechanisms for mitigating these personality risks. As it is evident from psychological research that there is a significant relationship between personality and behaviour, and considering that behaviour in corporate governance is a contributory factor to the failure of companies, in the case that less failure is desired, one clear means of helping to achieve the desired result is to ensure that the persons who are allowed into corporate governance have the potential to behave appropriately, and are particularly persons who are prone to abiding by principles and obeying regulations. This way, there is an increased likelihood that these persons will govern the companies more effectively because they are more likely at the least to abide by the established principles and regulations which are put in place to help guarantee effective corporate governance. In a situation where persons who have the potential to behave inappropriately are recruited as directors, it becomes imperative to identify the inherent personality risk and institute effective risk management processes in that regard so as to prevent corporate failures.

5.8 CONCLUSION

This chapter has explored the meaning of personality and its relationship to behaviour. It has established that personality has a significant impact on behaviour, and can therefore constitute a risk in relation to behaviour. The chapter has also illustrated that personality dimensions can be identified, and this connotes that personality risks can therefore be identified and managed. As corporate governance is essentially concerned with leadership and performance functions, there was also an analysis of how the facets of personality impact on leadership and job performance roles. Based on an analysis of the different personality dimensions and how they function, this chapter presented arguments regarding the personality traits which are best suited to the achievement of effective corporate governance. Again, based on the examples of corporate failures and an observation of the fact that one of the major contributory elements to the failures was the lack of dutifulness on the part of corporate officers, this chapter also argues that the dutifulness trait is the most essential in relation to corporate governance. It is the knowledge of what effective corporate governance entails and the fact that there are personality dimensions most appropriate to achieving this and a consciousness of the risks associated with inappropriate personalities in the corporate governance process, as well as an examination of relevant corporate and regulatory theories which leads to the development of the personality risk management model proposed in this

thesis, beginning with a conceptual framework for personality risk management discussed in the next chapter.

CHAPTER SIX

CONCEPTUAL FRAMEWORK FOR PERSONALITY RISK MANAGEMENT

6.1 INTRODUCTION

The two chapters preceding this have established an understanding of the problems that can emanate from personality and behavioural issues. Chapter four illustrated that personality and behavioural issues have contributed to corporate failures and in chapter five, the linkage between personality and behaviour was discussed. The conclusion reached from both chapters and a reflection on the discussions in chapter three is that personality risk impacts on behavioural risk. Therefore, in order to prevent the occurrence of corporate failures which are attributable to personality risks, there have to be mechanisms in corporate governance regimes which are instituted to manage these risks. This chapter discusses what needs to be achieved in the management of personality risks, presents some possible approaches to achieving this aim, indicates the preference for a hybrid regulatory approach and discusses the justification for adopting that approach in the development of the personality risk management model suggested in this thesis.

6.2 WHAT NEEDS TO BE DONE?

Risk management is a process which entails the recognition, identification and assessment of risk, and the development of strategies to mitigate it.⁶⁹⁶ As with the fundamentals of risk management as a concept in itself, managing personality risks involves recognising, identifying, assessing and mitigating risks associated with personality.⁶⁹⁷ Recognition of personality risks entails an awareness of the potential risks associated with personality traits. Identification entails obtaining a clear definition and parameter regarding personality traits so as to enable an effective judgment regarding what constitutes personality risk.⁶⁹⁸ It also means deciphering the aspects of personality which are relevant to the recognition of personality risks.⁶⁹⁹ Therefore, identifying personality risks means seeking to discover the personality traits which contribute to risk issues. For this to be achieved in the case of personality risks in relation to effective corporate governance, it would involve adequate

⁶⁹⁶ See generally the discussions on risk management in chapter three; see particularly notes 273-277.

⁶⁹⁷ Ibid.

⁶⁹⁸ See Hubbard, (note 275).

⁶⁹⁹ Ibid.

knowledge of what personality entails in relation to corporate governance processes and knowledge of the risk issues in corporate governance which are affected by personality traits.⁷⁰⁰ Regarding the identification and recognition of personality, the discipline of psychology provides the required information as the issue is essentially one of human psychology, and that is the school that has studied personality the most with tried and tested methods and can best explain what personality entails.⁷⁰¹

The personality risk issues which affect corporate governance can be identified by analysing debates, problems and approaches undertaken in corporate governance.⁷⁰² For instance, an analysis of various corporate failures illustrates that company directors disobeyed principles, rules and regulations, and so it can be deciphered that disobedience is a personality trait which can constitute risks in corporate governance.⁷⁰³ Assessing personality risks involves analysing the information obtained from the identification process and evaluating its potential effects in relation to corporate governance processes and outcomes. It means identifying the elements of personality which are likely to impact on the achievement of corporate objectives and result in a negative consequence, such as corporate failure. The assessment process provides a basis for the adoption of choices in relation to managing identified risks. Mitigating personality risks, as with the approaches involved in mitigating other categories of risks, could take various forms including avoiding the risk entirely, or taking steps and developing mechanisms to minimise its occurrence, its effects, or its impact.⁷⁰⁴ Avoidance of risks is an approach of risk management, however, it is also conceded that there are situations in which risks should not be avoided in their entirety;⁷⁰⁵ therefore, taking steps to impact on the occurrence or effect of risks becomes the most appropriate form of risk management in those situations.

⁷⁰⁰ See Van der Elst & Van Daelen, (note 274).

⁷⁰¹ See the discussions on personality in chapter five.

⁷⁰² See Kaplan & Garrick, (note 277); see also Merna & Al-Thani, (note 167).

⁷⁰³ See for instance the HIH, BCCI, Enron, and Lehman Brother failures discussed in chapter four.

⁷⁰⁴ See notes 273-277.

⁷⁰⁵ For instance, in corporate governance, a director may possess personality traits which places him in the category of neuroticism and he will be considered a personality risk because he has the potential to behave inappropriately, but that same director could also possess some traits which render him attractive to the company such as extraversion, in which case the company may decide that avoiding the personality risk in its entirety by electing not to recruit such a director is more disadvantageous, and the better option would be to recruit him and take steps to manage the personality risk he contributes to the management of the company.

6.3 APPROACHES TO MANAGING PERSONALITY RISKS

Some of the ways in which personality risks in corporate governance may be managed to varying degrees are as follows:

- 1) Hard Law/Criminal Law: Processes to manage personality risks could be entrenched in statutory provisions. For instance, legislation could mandate the identification and mitigation of personality risks, specifying the manner in which companies are to apply the provisions and providing sanctions for non-compliance. One disadvantage of such an approach would be that it would have to provide for every situation which it intends to cover, and that would prove onerous when it relates to processes for managing personality risks in different companies. This is because by the very nature of the subject, personality can differ and corporate governance needs can also differ, and change over time, depending on the company in question. Therefore, flexibility is necessary. Again, the processes involved in the promulgation of hard law are such that the law may not readily keep up with changing developments.⁷⁰⁶ Nevertheless, hard law in the form of statutory provisions can be of utility in cases where flexibility is not a key concern.

As a way of managing personality risks, provisions can also be entrenched in criminal laws which prohibit certain behaviours. Criminal laws refer to the body of rules and statutes that define conducts prohibited by the government because they threaten and harm public safety and welfare; and establish punishment to be imposed for the commission of such acts.⁷⁰⁷ Crime is generally defined as an act which is an offence against the community and attracts legal punishment.⁷⁰⁸ This means that behaviour is considered criminal only if it contravenes the criminal law and attracts punishment.⁷⁰⁹ Criminal law can originate from different sources such as the common law, statute, or regulatory provisions emanating from

⁷⁰⁶ Statutory promulgations involve the passage of legislation through parliament, a process which might involve extensive consultations and can become time consuming.

⁷⁰⁷ See the Legal Dictionary <http://legal-dictionary.thefreedictionary.com/Criminal+Law> (accessed 15th June 2012)

⁷⁰⁸ See R. Blackburn, *The Psychology of Criminal Conduct: Theory, Research and Practice* (Chichester: Wiley 1993) 5; see also the Legal Dictionary <http://www.legal-dictionary.org/legal-dictionary-c/Crime.asp> (accessed 15th June 2012); see also Crowther, (note 304) 18-19.

⁷⁰⁹ See Blackburn, *ibid.*

delegated legislation.⁷¹⁰ Persons may be deterred from behaving in ways which contravene the criminal law by the fact that the law prohibits such behaviours and also the possibility of criminal sanctions which result from being caught in such behaviours.⁷¹¹ Criminal law can, therefore, be used as a means to manage personality risks to the extent that particular behavioural tendencies which result from personality traits are specified as prohibited under criminal law. If behavioural tendencies are not viewed as crime, then criminal law is limited to the extent that it manages the risks emanating from personality traits resulting in such behaviours. An example would be the RBS case in which none of the company executives were charged with criminal offences simply because even though their behaviour contributed to the problems which occurred at the bank, there were no laws under which such behaviour could be judged.⁷¹²

Criminal law which specifies prohibited behaviour and punishment for the same would manage the personality risks which contribute to those behaviours to the extent that individuals are deterred from exhibiting such behaviours, either because the law prohibits it or because of the fear of punishment. In the event that individuals are not so deterred, one possible reason for the lack of deterrence being their personality, then criminal law fails in the management of such personality risks. Criminal law could also in certain instances provide for situations which are speculative to the extent that crime has not actually occurred but there is an assumption that it might occur.⁷¹³ In this way, criminal law can be

⁷¹⁰ See Crowther, (note 304) 20.

⁷¹¹ There are various arguments as to why criminal laws are obeyed and disobeyed. Criminologists argue that crime is simply behavioural responses to social conditions, see C. Sumner, 'The Social Nature of Crime and Deviance' in *The Blackwell Companion to Criminology* (Oxford, UK: Blackwell Publishing Ltd 2004) 9. Tyler argues that people obey the law if they believe it is legitimate and not because they fear punishment, see T.R. Tyler, *Why People Obey the Law* (Princeton, New Jersey: Princeton University Press 2006). Psychology literature indicates that some personality traits, such as the dutifulness trait in conscientious personalities, portray a higher propensity to abide by moral obligations such as obeying laws, see Christopher, Zabel & Jones, (note 380). Crowther states that psychological theories of crime begin with the view that individual differences may make some people more predisposed than others to commit criminal acts, see Crowther, (note 304) 281.

⁷¹² See the RBS example in chapter four, section 4.3.7.

⁷¹³ See for instance the provisions under s 1 of the Police and Criminal Evidence Act 1984; s 60 of the Criminal Justice and Public Order Act 1994; s 44 of the Terrorism Act 2000 which deal with the powers conferred on the police to stop and search persons upon reasonable suspicion that a crime might be committed, note that the European Court of Human Rights delivered a judgment in the case of *Gillan and Quinton v United Kingdom* [2009] ECHR 28 (12 January 2010) which declares the application of s 44-47 of the Terrorism Act 2000 illegal stating that it contravened the provisions of Art 8 of the European Convention on Human Rights which deals with privacy.

described as a means of managing personality risks because the provisions operate on the basis of the potential for a crime to be committed, even though the actual crime may not have been committed. This means that criminal law can provide for pre-emptive situations and this is a form of risk management.⁷¹⁴

Likewise, in respect of corporate governance mechanisms, there could be provisions in criminal law specifying that individuals with certain personality dimensions should not be recruited as company directors based on their potential to mismanage companies, or that certain safeguards should be put in place if such personalities are recruited. However, it is important to note that incorporating such provisions into criminal law would also depend on issues such as a society's view of behaviour that should be criminalised.⁷¹⁵ Again, as discussed earlier, in relation to managing personality risks and the processes involved in doing so, it might be challenging for criminal law provisions to provide for every possible situation. In conclusion, criminal law could be utilized as an approach to managing personality risks only to the extent that the provisions of the law specify specific prohibited behaviours and individuals are influenced in their behaviour by the provisions of the law. Also, any legislation which seeks to manage personality risks must incorporate the essential risk management processes of recognition, identification, assessment and mitigation of risks.

- 2) Insurance: A contract of insurance is one in which one party in consideration of the price paid to him proportionate to the risk provides security to the other party that he shall not suffer loss, damage or prejudice by the occurrence of certain specified events.⁷¹⁶ Insurance provides economic protection against losses that may be incurred due to chance events that may or may not occur during the effective time of the insurance contract referred to as a policy.⁷¹⁷ Insurance policies can manage personality risks to the extent that specific risks are identified and evaluated, with an economic cost attached to the crystallisation of such risks.

⁷¹⁴ See notes 273-277.

⁷¹⁵ See Crowther, (note 304) 19-20.

⁷¹⁶ See P.K. Gupta, *Principles and Practice of Non-Life Insurance* (Mumbai, India: Global Media 2009) 8.

⁷¹⁷ Ibid. Crime or fidelity insurance is taken out by companies to guard against issues such as employee dishonesty, embezzlement, fraud, and forgery. See G. Anderson, 'The Emergence and Development of Fidelity Insurance in 19th Century Britain' (2004) 29(2) *The Geneva Papers on Risk and Insurance* 234-246; see also E.G. Gallagher & R.J. Duke, 'A Concise History of Fidelity Insurance' in M. Keeley & S. W. Duffy (eds.), *Handling Fidelity Bond Claims* (United States: American Bar Association Publishing 2005) 1-23.

Therefore, the policy influences the impact and effect of the risk after the event has occurred. However, it is ineffective in relation to influencing the occurrence of the risk in question which in this case entails managing personality risks in a manner that prevents the occurrence or reduces the chances of occurrence of the risk events. For instance, the Lehman Brothers company took out insurance policies to offset liabilities and settle law suits which might be filed against its executives.⁷¹⁸ These insurance policies would help the company recover economic losses resulting from law suits in relation to the corporate failure. But, the impact of the failure on the rest of society still remains, and the insurance process did not prevent the failure. The insurance policies only compensated for the economic losses which were specifically addressed by the policies.

To the extent that the exact economic losses that might possibly result from the occurrence of an event such as a corporate failure remain unknown, and there are possibilities of losses which might not be economically quantifiable, then insurance would not be the most appropriate approach to managing personality risks. Again, if the aim of a risk management process is to adopt proactive means of influencing the occurrence of risk events, and not just to influence risk outcomes after the event, then insurance policies would not achieve the aim. In corporate governance for instance, if the objective is to take steps which manage personality risks in order to reduce the occurrence of corporate failures resulting from personality risks that cause inappropriate behaviour, then taking out an insurance policy to compensate for losses which would occur in the event of such corporate failures is hardly an effective approach towards preventing the occurrence of such failures. Another issue is that if insurance is the option selected for managing personality risks, and companies are allowed to approach different insurance companies to obtain policies in that regard, then it means that insurance companies would become risk assessors as they have to evaluate the risk which is sought to be insured. In the absence of a standard measure, different companies would arrive at varying perceptions of personality risks and this is bound to influence the premium on the policy. If the cost of insurance is viewed as too high, then companies may decide not to take out policies. Again, if risks are viewed as too costly, insurance companies may decide not to offer policies in

⁷¹⁸ See The Lehman Brothers example in chapter four, section 4.3.6.

those respects. In any case, insurance impacts on personality risks only to the extent that it helps minimise the effects of the occurrence of events associated with these risks. It is not an effective risk management tool from the perspective of preventing the occurrence of events and losses.

- 3) **Soft Law/Self-Regulation:** A framework for personality risk management could utilize soft law recommendations and could in fact be incorporated into existing corporate governance codes and guidance, or other soft law regulatory mechanisms. An advantage of this approach would be the flexibility afforded by the nature of soft law provisions.⁷¹⁹ However, in areas where effectiveness would be undermined if there is scope for non-compliance, then the soft law approach becomes inadequate.⁷²⁰ One fundamental concern in relation to corporate governance codes in the UK relates to the “comply or explain” approach, as it creates a risk that the framework may not be followed with consequential impact on its overall effectiveness.⁷²¹ The level of discretion inherent in the application of soft law mechanisms such as corporate governance codes is such that they would not be the best vehicles through which regulatory provision which are considered most effective as mandatory provisions should be deployed.⁷²² Nevertheless, soft law approaches may be suitable in cases where flexibility would aid the effectiveness of the provisions, or inflexibility would undermine the overall aims of the provisions, such as where different approaches may need to be adopted considering varying circumstances. For instance, in the event that companies in different sectors of the economy require different dimensions of personalities to govern the companies effectively, these companies would need to adapt their personality risk management processes to suit their needs and this would be achieved better with the provision of soft law mechanisms which allow room for flexibility. Providing mandatory requirements for all companies in a blanket manner and irrespective of their peculiar circumstances might undermine the effectiveness of some regulatory provisions.⁷²³ In these cases, soft law

⁷¹⁹ See Bartle & Vass, (note 231); see also Ogus, (note 231).

⁷²⁰ See Bartle & Vass, *ibid*.

⁷²¹ See generally the arguments on the ineffectiveness of the “comply or explain” approach of the UK Corporate Governance Code in chapter three, section 3.5.

⁷²² *Ibid*.

⁷²³ For example, in relation to personality risk management provisions, mandating that companies operating in the customer services sector (with directors who are predominantly extroverts) should manage their

approaches may suffice as long as the essential aims of the regulatory provisions are still met, which in this case would be the institution of a personality risk management process in every company.

- 4) Professionalization/Certification: Directorships could be professionalised to the extent that only appropriate personalities depending on agreed criteria are accredited to govern companies. This process would involve an identification and assessment of personality risks which are considered acceptable or unacceptable for becoming a company director. There could be an established agency or agencies, or bodies which are accredited to conduct personality tests and issue certification based on approved criteria. These agencies or bodies may be governmental or external to the State, such as professional bodies. Hypothetically, a person who wishes to be recruited as a company director would be required to present a certificate from an approved body indicating that his/her personality is such that is appropriate for corporate management. Some of the issues which may arise with processes such as this include standardisation of the accreditation process and sustainability of the process. It would be most effective if similar high standards are applied in the test issued by every accrediting body, and no circumventions are allowed. In the case that there is a single accreditation body, standards may be sustained, however, it might be challenging to have only one accreditation body considering the number of persons who may need to access the services. Again, directors who are not accredited would stand the risk of being excluded from corporate governance entirely, even if they possess some other useful skills, knowledge and experience.

This accreditation process would therefore manage personality risks mostly from the basis of avoiding the risk. As was noted earlier in the chapter, in section 6.2, there are some situations in which avoidance of risks in its entirety may not be the most advantageous approach towards managing personality risks and attaining corporate goals at the same time. Therefore, if the process simply excludes

personality risks exactly the same way as companies in the financial services sector (with directors who are mostly conscientious personalities) might be problematic because these personalities are different, and so are the companies, therefore outcomes are bound to differ. These different companies might need to apply different levels and standards of personality risk management, and only a flexible mechanism would allow that. Mandatory provisions can only achieve the same aim to the extent that they provide for every possible circumstance, and as has been discussed earlier in relation to criminal law, that is a challenging task, and could also prove costly.

directors who do not “qualify”, then it may also be excluding other positive potentials and the overall personality risks in relation to achieving corporate governance objectives might have been managed more effectively under a more flexible risk management process. In the case that the accreditation process serves as a mere risk identification activity, and the shareholders are still allowed to select directors as they deem fit regardless of whether they “qualify” or not, then the process only succeeds in managing personality risks from the perspective of risk identification. There would still be a need to institute risk management processes for those identified risks, if effective risk management is to be achieved.

- 5) Information and Disclosures: As an alternative to regulation, information regarding personality risks, such as the personality dimensions best suited to corporate governance, potential risks which exist in relation to different personality dimensions as well as processes for managing personality risks, could be made available by the State to companies and the market, and shareholders and companies could be left to utilise this information in the selection and risk management of company directors. However, there will still be a need to identify the personality dimension of individual company directors as it is only when the identification exercise is carried out that any information relating to their potential personality risk becomes meaningful. This is because having knowledge of the import of personality risks and risk management processes can only be utilised in practical terms as it relates to specific companies when the personality dimension of the company directors in question are known. Therefore, simply providing information regarding personality risks will not achieve the aims of personality risk management. Moreover, if shareholders and companies are not obliged to act upon the information provided, it further defeats the aims of the risk management process. The provision of information regarding personality risks will only manage the risks to the extent that shareholders and companies are made aware of the existence of such risks, and they can now elect to actively engage in processes which identify and manage the risks as it relates to their companies.
- 6) Economic Incentives and Detriments: Flowing from the provision of information, the State could provide economic incentives for companies that act upon the information regarding personality risks by selecting directors who are best suited to corporate governance and adopting personality risk management processes in

cases where directors that are not best suited to corporate governance are selected. Economic detriments could also be provided for companies that do not act on the information provided. This approach will manage personality risks to the extent that the incentives and detriments might encourage companies to act upon the information and engage with personality risk management processes. Under this approach, companies could be given tax rebates for the reason that they have decided to act in accordance with the information provided by the State. Also, companies could be surcharged in taxes for deciding not to adopt any personality risk management processes. Some level of regulation will be required in order to establish these economic incentives and detriments, however, the level of regulation is not likely to be as detailed as would be required in the case that the State decides to regulate directly on the issue of personality risk management. One reason why this approach will not be effective in terms of ensuring that personality risks are managed across companies is that the companies are allowed to make their choices as to whether to act upon the information provided, and if the economic incentive or detriment does not make any meaningful difference to a company, it can decide to ignore the information relating to personality risks and select its directors as it deems fit. Therefore, this approach will manage personality risks only to the extent that companies are influenced by the economic incentives and detriments and are encouraged to embark on the identification of personality risks and to engage with personality risk management processes.

- 7) Hybrid regulation/Mix of hard and soft law: There could be a hybrid regulatory model developed to manage personality risks. This process would involve identification, assessment and mitigation of the risks. An advantage of such an approach is that hard law provisions can be applied where necessary and they would stand a higher chance of being adhered to as they would have the force of law. Essentially, hard law would be the most appropriate approach in situations where the aim is to enforce minimum standards.⁷²⁴ Considering the utility of flexibility in certain cases, soft law recommendations can be applied in situations where it is deemed necessary,⁷²⁵ especially in recognition of the preference for

⁷²⁴ See L.L. Fuller, *The Morality of Law* (Revised ed., Yale: Yale University Press 1969).

⁷²⁵ As in the example discussed earlier where one size does not fit all companies and risk management processes would have to be adapted to fit the peculiar needs and architecture of different kinds of companies.

soft law approaches in corporate governance.⁷²⁶ As with similar recommendations in corporate governance codes, these soft law provisions would be viewed as best practice.⁷²⁷ Such a hybrid approach could cater for different circumstances under generalised provisions, a situation which might not ordinarily be obtainable under strict hard law provisions which are usually made to provide for specific situations. As was noted earlier, behaviour can only be criminal if it is specifically provided for as such under the criminal law.⁷²⁸ A regulatory mechanism which provides blanket provisions which are then capable of being applied to different circumstances would prove better at managing personality risks because a wider range of potential behaviour could be captured into the spirit of its provisions, and it would not matter that each specific behavioural issue had not been spelt out.⁷²⁹

The ability to incorporate both mandatory and flexible provisions in a hybrid mechanism makes it the most attractive approach in personality risk management because there are various issues which can result from the existence of various personality dimensions and different companies may have different needs, as well as goals and objectives. If the aim is to adopt an approach which would prove most effective taking cognisance of the fact that in corporate governance one size does not fit all, then a mixture of regulatory instruments which mandates behaviour where necessary in order to aid effectiveness and allows flexibility within reason would be the better approach. In discussing regulatory design, Gunningham & Grabosky argue that adopting a mix of regulatory instruments and applying only the minimum required to achieve the purpose of the regulation is the best approach.⁷³⁰ They indicate that hard law is dependable and predictable but could also be inflexible and inefficient, whilst soft law is cost effective and

In these cases, basic recommendations are provided, and companies are then allowed to engage with these recommendations as applicable to them.

⁷²⁶ Corporate governance recommendations have often come by way of soft law provisions as business men have historically preferred to govern themselves and State intervention is usually restricted to areas and circumstances in which it is absolutely necessary. It has been argued that the UK in particular appears to be “a haven for self-regulation”, see R. Baggot, ‘Regulatory Reform in Britain: The Changing Faces of Self-Regulation’ (1989) 67 *Public Administration* 435 at 438.

⁷²⁷ See the UK Corporate Governance Code 2010, p 1.

⁷²⁸ See Blackburn, (note 708).

⁷²⁹ See Bartle & Vass, (note 231).

⁷³⁰ See Gunningham & Grabosky, (note 203).

flexible but could be unreliable.⁷³¹ Therefore, the best way to overcome the disadvantages of these different regulatory approaches is to combine both approaches in the best way that achieves the regulatory purpose.⁷³²

Also, the EU Better Regulation agenda provides that in designing policies, laws and regulations, governments are looking to employ the most appropriate regulatory tools which will maximise benefits and minimise negative effects.⁷³³ A hybrid mechanism which utilizes the minimum regulatory intervention required to achieve the purpose is therefore the better option in relation to managing personality risks. The most important aspects of personality risk management in which compromise should be avoided, because those aspects represent the minimum standards in relation to personality risk management, are the identification process and the requirement to institute a personality risk management mechanisms.⁷³⁴ In regard to these aspects, hard law is recommended. This is because hard law is the best approach to utilize in the setting of minimum standards for reasons of clarity and conformity.⁷³⁵ However, considering the peculiarities of companies as discussed earlier, soft law mechanisms are recommended in relation to provisions for managing personality risks in companies for reasons of flexibility and efficiency.⁷³⁶

6.4 INDICATORS OF EFFECTIVENESS

The idea of managing personality risks in the best way possible is simply to ensure the effectiveness of the process and increase the likelihood of the process achieving its aims. It would make little or no sense to expend efforts towards managing personality risks and at the end of it all, the risks being managed still lead to an unwanted negative outcome. In relation to judging the effectiveness of risk management regimes, the COSO Framework gives an indication of what that entails. Essentially, in order to adjudge a risk management process

⁷³¹ Ibid.

⁷³² Ibid.

⁷³³ See the EU Better Regulation Brochure

http://ec.europa.eu/governance/better_regulation/documents/brochure/br_brochure_en.pdf p 3 (accessed 15th June 2012).

⁷³⁴ These aspects are the most important areas because from the discussions on risk undertaken in chapter three, risk must be identified in order to be managed, and risk management is essential for the achievement of corporate objectives.

⁷³⁵ See Fuller, (note 724); see also Gunningham & Grabosky, (note 203).

⁷³⁶ See Gunningham & Grabosky, *ibid.*

effective, eight elements have to be present and functioning effectively.⁷³⁷ These eight elements are internal environment, objective setting, event identification, risk assessment, risk response, control activities, information and communication, and monitoring.⁷³⁸ Therefore, an effective personality risk management process is one that takes cognisance of these issues and ensures that these elements are present and functioning. This means that in order to attain an effective personality risk management process, personality risks must be identified in an appropriate environment in which clear objectives are set, there must be processes in place to assess and respond to the risks, with adequate information being made available, as well as the risk management activities being monitored.

Taking account of the requirements needed to demonstrate effectiveness; this thesis proposes a hybrid regulatory model for the management of personality risks in corporate governance. It argues that mandatory provisions should be adopted in situations where, as discussed earlier, the issues at stake are fundamentally important and conformity is necessary in order to aid effectiveness. Soft law recommendations are then proposed in cases where differences in circumstances exist and flexibility is essential in order to achieve the overall aims of the model which is the identification and management of personality risks. Mandatory provisions are considered necessary in situations where compromises could undermine effectiveness. For instance, health and safety regulations are usually mandatory because it is not reasonable to compromise on conformity in life threatening situations such as those.⁷³⁹ The impact of corporate failures on individuals and society as a whole would illustrate that corporate governance is an important area of activity, with life threatening implications in certain cases where corporate governance mechanisms fail.⁷⁴⁰ The most effective solutions to personality risk management would be those which engender higher levels of effectiveness across the entire corporate governance process, and these solutions should begin with the identification and recruitment of the most appropriate company directors, and provide for an effective risk mitigating process in the case that inappropriate directors are recruited. The hybrid regulatory regime proposed in this thesis is aimed at achieving this.

⁷³⁷ See the COSO Framework, (note 175) 3-5.

⁷³⁸ Ibid.

⁷³⁹ See for example the UK Health and Safety Regulations which specify mandatory actions which employers must undertake to provide health and safety at work, <http://www.hse.gov.uk/pubns/law.pdf>, (accessed 15th June 2012); see s 2 of the Health and Safety at Work etc. Act 1974 which specifies the general duties of employers to their employees.

⁷⁴⁰ Corporate failures have led to loss of lives and livelihood; see for instance the Enron case discussed in section 4.3.4 in which one of the executives committed suicide.

6.5 WHY A REGULATORY REGIME?

A starting point in respect of the justification for regulatory intervention is a discussion on corporate and regulatory theories. These theories enable an understanding of the approaches adopted in practice as it relates to regulatory intervention in the management of companies. The contractual theory of the firm posits that State intervention in the form of regulation should not occur except in cases of market failure, where the regulation should be aimed at correcting market failures.⁷⁴¹ The concession theory argues that companies are open to State regulation.⁷⁴² One problem with the contractual theory is that it seeks to rely on private law mechanisms as against public law mechanisms and the danger inherent in that is that the public might not be adequately protected because individuals and firms would usually only seek to enforce rights in cases where expected benefits to themselves exceed expected costs and thereby creating the risk that some legitimate claims would be ignored.⁷⁴³ This means that profit maximisation could get in the way of protecting public interest. Accordingly, Riley argues that certain constraints should be satisfied before profit maximisation decisions are taken and the goal of the company is actually unchanged by the constraints imposed by society's norms.⁷⁴⁴ Therefore, since the company exists within society, it should conform to minimum standards which support its existence within that society.⁷⁴⁵ It means that the pursuit of profit should not be an excuse to infringe on societal norms.

The elements of corporate existence which are beneficial to society as a whole should form some basis for the norms which society should impose on companies. It should mean that companies have to abide by certain constraints aimed at protecting the public interest.⁷⁴⁶ It has also been argued that State regulation is viewed as justifiable in cases of market imperfections, particularly information asymmetries, which make it difficult for market participants to accurately assess the risks they take in dealing with companies.⁷⁴⁷ Cheffins⁷⁴⁸ explains the perfect market as one in which actors “act rationally, are numerous, have full information about the products on offer, can contract at little cost, have sufficient financial resources to transact, can enter and leave the market with little difficulty, and will carry out

⁷⁴¹ See Ferran, (note 215) 387.

⁷⁴² See Dine, (note 49) 29.

⁷⁴³ See Ogus, (note 197) 27.

⁷⁴⁴ See C. Riley, ‘Understanding and Regulating the Corporation’ (1995) 58 *Modern Law Review* 595.

⁷⁴⁵ Ibid.

⁷⁴⁶ See Dine, (note 49) 29.

⁷⁴⁷ See Ferran, (note 215) 387.

⁷⁴⁸ See Cheffins, (note 375) 6.

the obligations which they agree to perform”.⁷⁴⁹ Based on Cheffins’s explanation of the perfect market scenario, a number of conclusions can be reached:

- 1) Market participants would be acting rationally when they seek to create benefits for themselves within acceptable rules in the market transactions and avoid losses;
- 2) Market participants need adequate information to be in the best position to make adequate decisions regarding their participation in the market;
- 3) Market participants need baseline rules which enable them achieve their aim within the market at the least cost;
- 4) Market participants need the market to function effectively with minimal losses so that there can be sufficient financial resources available in the market;
- 5) Market participants need to carry out any obligations which they agree to perform.

Some further observations arise out of the issues listed above. First, inadequate information is an issue which reflects imperfection in the market and it becomes relevant in relation to understanding the utility and justification for mechanisms suggested in this thesis to address the problems of inadequate information in markets. Second, there is a justification founded on the contractual theory for State regulatory intervention to ensure markets are functioning effectively with minimal losses, as ineffective and loss prone markets also depict imperfection.⁷⁵⁰ Third, in a perfect market, it is vital for participants to actually undertake any agreed obligations.⁷⁵¹ It becomes important therefore for these participants to be persons who are capable of undertaking such obligations. In a situation where market participants are persons who do not have the ability to carry out their obligations, the market is inherently a failure,⁷⁵² and a need arises for mechanisms to correct this failure. The above cases represent some of the issues which the regulatory model proposed in this thesis seeks to address, and provides justification for the selected approach.

Cooter highlights the difference between economic perspectives of regulation and the legal perspectives of the same by pointing out that economists ignore the internalisation of norms which leads to the “rational” behaviour which they consider to be inherent in free market

⁷⁴⁹ Ibid.

⁷⁵⁰ See Ferran, (note 215) 387.

⁷⁵¹ See Cheffins, (note 375) 6.

⁷⁵² Ibid.

participants.⁷⁵³ He argues that economics does not explain how people acquire their goals when in fact a person acquires values by internalising them. This internalisation of norms in a community occurs by cooperation to acquire a local public good and once this behaviour is seen as valuable it becomes a norm of that society, and therein is the role of law.⁷⁵⁴ The law exerts influence on behaviour over a period of time. Therefore, if there is to be an actual act of rationality amongst market participants at some point, then it must be as a result of the internalisation of requisite norms over time.⁷⁵⁵ This means that if the law helps in the internalisation of norms, then there is a vital place for State regulation within the markets. Again, if the view of the contractual theorists is that the principal purpose of a company is profit maximisation, it follows that State regulation would have to be aimed solely at supporting this proposition and enabling companies to maximise profit, even if it is to the detriment of society.⁷⁵⁶ This position of contractual theorists would lead to minimal restraint on managerial power and would also leave room for expropriation by majority shareholders who can manipulate the company's constitution.⁷⁵⁷ It also ignores the position of the company within society and that companies serve to enhance interests other than those of its shareholders.⁷⁵⁸ Therefore, even though the principal purpose of a company may be profit maximisation from the perspective of its shareholders, regulation in the interests of the company should take cognisance of the other factors which may have an impact on this principal purpose of the company.⁷⁵⁹

The contractual theory argues that the shareholders should be assigned the major role of regulating companies so as to align the interests of management with their interests.⁷⁶⁰ That seems reasonable, because the shareholders are the owners of the company in principle, but then these interests still differ and problems arise, which is one of the reasons why corporate governance became an issue in the first place; as shareholders had to find means of aligning and monitoring these interests on a continual basis.⁷⁶¹ But, can shareholders be expected to align the interests of company management boards with that of the public or stakeholders?

⁷⁵³ See R. Cooter, 'Law and Unified Social Theory' (1995) 22 *Journal of Law and Society* 50-61.

⁷⁵⁴ Ibid.

⁷⁵⁵ Ibid.

⁷⁵⁶ See Dine, (note 49) 113-114.

⁷⁵⁷ See Dine, *ibid* 116.

⁷⁵⁸ Stakeholder theory arguments posit that the role of companies goes far and above the maximisation of shareholder wealth. See Freeman, Wicks & Parmar, (note 77) 364; see also Letza, Sun & Kirkbride, (note 67) 250; see also Donaldson & Preston, (note 77) 65-91.

⁷⁵⁹ See Sundaram & Inkpen, (note 60); see also Gillan, (note 60).

⁷⁶⁰ See Dine, (note 49).

⁷⁶¹ See the discussion on corporate governance in chapter two, section 2.3.

That is not very likely because company boards might be focused on profit maximisation, to the detriment of stakeholder interests. Again, where shareholders themselves are focused on profit maximisation, they might not be in the best position to take cognisance of the interests of the public which might not contribute towards their own goals.⁷⁶² Therefore, there must be mechanisms for protecting the interests of the public and other stakeholders.⁷⁶³

The State intervenes in the regulation of companies presumably to serve both the company's interests and the public interest as the company being a creation of the State and functioning within society is essentially fulfilling roles which go beyond the goals of its shareholders.⁷⁶⁴ The company indeed fulfils roles far and beyond the interests of its shareholders, including, for example, the provision of jobs, economic capital, essential services and its continued existence in the market itself promotes confidence in capitalism.⁷⁶⁵ A vibrant market for goods and services is a necessity in a society especially where the government does not provide all the goods and services needed by the populace. A commercial entity has to generate profit in order to sustain its existence in the market place. Therefore, State intervention by way of regulation should actually be in the interests of the company in terms of aiding its survival and also in the interests of the public in terms of protecting societal goals.⁷⁶⁶ The profit maximisation goal of a company is not necessarily a mutually exclusive issue from the protection of public interest, because the public can only benefit from a company that is in existence in the market.⁷⁶⁷ However, the State appears to be in a better position than shareholders to protect the interests of the public, as it would be a more objective stakeholder, and part of the public interest is also to support profit maximisation because a company which does not make profit would not continue to exist in the commercial sphere, thereby limiting the possibility of that company to fulfil its other roles to the public.⁷⁶⁸

⁷⁶² See Webb et al, (note 58); see also Dine, (note 49) 30-31.

⁷⁶³ See Dine, *ibid* 35.

⁷⁶⁴ See Dine, *ibid* 29; see also Lan & Heracleous, (note 38).

⁷⁶⁵ See the Cadbury Report (para 1.1) which states in regard to the setting for the report that the country's economy depends on the drive and efficiency of its companies.

⁷⁶⁶ See Ferran, (note 215); see also Dine, (note 49).

⁷⁶⁷ The important issue would be that the drive for profit maximisation is undertaken within the principles, rules and regulations which are promulgated to safeguard the company from risks which could result in a truncation of corporate objectives and lead to the demise of the company; see the Revised Turnbull Guidance, (note 170).

⁷⁶⁸ See Dine, (note 49) 29-31.

The salient issue is that a company that is managed effectively is more likely to generate profit for its shareholders especially in the long term, and so any regulation which supports the effective management of companies is invariably fulfilling all the tenets of acceptable regulatory intervention as argued by both the contractual and the concession theories.⁷⁶⁹ Ineffective management is a sign of market imperfection as was noted above,⁷⁷⁰ so regulatory intervention to remedy that situation should be acceptable according to the contractual theory. Also, the concession theory supports the intervention of the State in matters of public interest and it is clearly in the interest of the public that companies are properly managed.⁷⁷¹ Where a proposed regulatory intervention is in keeping with the underlying philosophies of both the contractual and concession theories, as is the case of regulation which is aimed at enabling effectiveness in the management of companies in order to achieve whatsoever might be their corporate goal, then the question of differences in ideology between both theories becomes less important. Considering these theoretical perspectives on regulation in the corporate sphere, it is evident that regulatory intervention is justifiable in cases which are supported by the tenets of the theories, especially when it is an effective option as regards achieving the desired outcome.⁷⁷²

6.6 CORPORATE AND REGULATORY THEORIES IN THE MANAGEMENT OF PERSONALITY RISKS

Taking account of the various corporate and regulatory theories discussed in the previous section,⁷⁷³ the following arguments indicate, from a practical perspective, the desirability, necessity, modality and acceptability of a regulatory intervention in the management of personality risks in corporate governance. These analyses also highlight the influences drawn from these theories in the development of the regulatory model in this thesis.

1) Contractual / Concession theory:

The reasoning behind the contractual theory is that a company is a creation of contract between the owners and the managers and should be regulated by the creators and

⁷⁶⁹ See Freeman, Wicks & Parmar, (note 77) 366; see also M. Pirson, 'What is Business Organizing for?-The Role of Business in Society Over Time' (2010) *Fordham University Schools of Business Research Paper No 2010-015*, <http://ssrn.com/abstract=1601644>, 11 (accessed 15th June 2012), where it is stated that whether one sides with the stakeholder or the shareholder argument, both camps seem to support the need for more ethical management.

⁷⁷⁰ See Ferran, (note 215); see also Cheffins, (note 375).

⁷⁷¹ See Dine, (note 49) 29; see also Lan & Heracleous, (note 38).

⁷⁷² See Ferran, (note 215); see also Dine, *ibid*; see also Lan & Heracleous, *ibid*.

⁷⁷³ These theories are discussed in greater detail in chapter two.

allowed to operate freely within the market.⁷⁷⁴ However, there are justifications for the State to intervene in cases where the market has failed.⁷⁷⁵ Accordingly, it has been stated that “the preferred remedy is to improve the operation of the market by reducing or eliminating imperfection”.⁷⁷⁶ The lack of mechanisms to identify and manage personality risks constitutes a form of market imperfection, therefore, regulation that aims to achieve this end and is applied at a level and style which is commensurate with the market failure which it seeks to address should be considered necessary and adequate because it conforms to corporate and regulatory theories.⁷⁷⁷ In the concession theory, the State intervenes in the regulation of companies as the company is a creation of the State, acquiring its being from a State concession.⁷⁷⁸ Regulation of companies is then viewed as a necessary part of the grant of that State concession. It is undoubtedly in the interest of the State as representative of the public that personality risks in companies are managed, so any regulation in this regard is desirable.

2) Market failure/ Risks/ Public interest:

The market failure theory argues that in a liberal-capitalist society, the State will be pressurized to restrict its interventions to the minimal level necessary to correct market failure, and market failure is widely considered as a rational basis for regulatory intervention.⁷⁷⁹ If investors in the market place do not have adequate information regarding the personality of company directors, as their personality contributes to their behaviour in corporate governance, these investors buy into the company with no knowledge of an aspect of the risks they undertake in their investments, which is hinged on the personality of company directors as managers of their investment. These risks range from a depletion of their investment to an outright failure of the company. Risk may be an essential element of business undertakings,⁷⁸⁰

⁷⁷⁴ See Lan & Heracleous, (note 38); see also Jensen & Meckling, (note 29); see also Bottomley, (note 42); see also Sugarman & Rubin, (note 43); see also Kraakman, (note 40); see also Coase, (note 25).

⁷⁷⁵ See Ferran, (note 215) 387.

⁷⁷⁶ See S. Elkin, ‘Regulation and Regime: A Comparative Analysis’ (1986) 6(1) *Journal of Public Policy* 49-72 at 51.

⁷⁷⁷ See Ferran, (note 215); see also Dine, (note 49); see also Gunningham & Grabosky, (note 203); see also Ayres & Braithwaite, (note 178).

⁷⁷⁸ See Dine, *ibid*; see also Lan & Heracleous, (note 38).

⁷⁷⁹ See C. Hood, H. Rothstein & R. Baldwin, *The Government of Risk: Understanding Risk Regulation Regimes* (Oxford: Oxford University Press 2001) 70; see also Ferran, (note 215).

⁷⁸⁰ See the Turnbull Guidance, (note 169); see also the Revised Turnbull Guidance, (note 170).

but the inherent risk which accrues to the entire governance process by virtue of the personality of company directors is a vital piece of information which should be made available to the market participants because it has a profound effect on the prospects of their investments. Having directors whose personalities are high risk without adequate personality risk management procedures in place is likely to increase the risk of corporate failure.

A company may fail due to business risks which were clearly and rationally undertaken. However, if the company directors were people with appropriate personality dimensions for corporate governance, the chances are higher that they would have taken on those risks with clarity of purpose and in compliance with the measures established for such business dealings. It may then be assumed that such a company failed because of the natural propensity of business risks to result in negative outcomes in some instances. The failure would not have occurred merely because of the fact of having less than appropriate personalities taking on business risks which were not thought through because they did not have the ability to think things through, or for the reason that the company directors took actions which run contrary to established processes of governance because they are not the kind of personalities that are dutiful and abide by rules and regulations. In the latter case, it would be said that the company failed because of the personalities of the company directors who took on decisions and actions which contributed to the failure and not merely the natural propensity of business risks to make or break a company.

Examples of corporate failures examined earlier illustrate the considerable impact of personality and behaviour in actions and decisions which can contribute to corporate failures. Therefore, investors need to know the nature of the personality of company directors in the companies in which they are investing. The availability of this category of information is as important as the availability of other pieces of information which are mandatorily made available to enable the effective functioning of the market under the contractual theory. For instance, company directors are required to send their shareholders the annual accounts of the company, which should represent a true and fair view of the company.⁷⁸¹ One of the underlying principles behind this disclosure is that the shareholders need to know how the company is

⁷⁸¹ See s 393 and 423 of the UK Companies Act 2006.

performing, so as to determine the prospects of their investments. As it is argued that the personality of company directors plays a role in their ability of to manage the affairs of the company effectively, then information relating to their personality is equally one which is essential for the market as it also aids investors in determining the prospects of their investments. This piece of information is in the sphere of knowledge which is needed to create an effectively functioning market in which decisions are made based on full and adequate knowledge. It is therefore important that regulatory measures are taken to address this information asymmetry and in accordance with the contractual theory, any regulatory measure in this regard should be acceptable.

Also arising is the issue of the appropriate level of regulatory intervention. Contractual theorists argue that the State should intervene in the most minimalistic manner required to address the issue of market failure.⁷⁸² The least that the State can do in this case is to mandate companies to make the required information available as any other mechanism which does not create a definitive obligation on the part of the company to provide this piece of information will not address this market failure. The State has a duty to develop and protect the market by underpinning informed choices. In the case that companies do not as at yet see the need to volunteer this information as a necessary part of corporate disclosure, it then makes sense that it should be mandated. There is a need to create uniformity and similar standards across the board of public listed companies and so it becomes important to ensure that all such companies are undertaking the process and making the necessary disclosures regarding the personality of its directors. Transaction costs are also reduced when regulatory intervention creates similar standards across companies.⁷⁸³ This is because companies are expected to abide by the default regulatory rules already established and they are saved the process of determining what mechanism might achieve the same purpose and seeking to incorporate these mechanisms individually.

Having an effective market is beneficial for both the companies and the market participants who represent the entire public.⁷⁸⁴ There are negative consequences for

⁷⁸² See Ferran, (note 215); see also Hood et al, (note 779).

⁷⁸³ See Ferran, *ibid*.

⁷⁸⁴ See Cheffins, (note 375).

society as a whole when a public company experiences failure.⁷⁸⁵ These consequences range from capital losses, job losses, negative social effects, loss of confidence in the markets and capitalism, loss of availability of goods and services for the wellbeing of the populace. Corporate failures would usually also create a loss of confidence in the associated regulatory environment.⁷⁸⁶ This is so even in cases where there existed no direct State regulation in the sphere of corporate activities which caused the corporate failure because the public simply trusts the State to protect it from afflictions of every kind.⁷⁸⁷ Therefore, the public expects the State to ensure that companies are governed effectively in order to minimise losses especially of the kind that affects the general public negatively. The personality of company directors is a risk issue. If company directors are persons with personalities which are high risk and therefore not the most appropriate for governance and there is no measure put in place to effectively manage the risks which accrue by virtue of the presence of these personalities, the risk of corporate failure is increased across board. The State, in fulfilling its responsibility to safeguard the society from public losses and in ensuring that markets are functioning effectively in order to promote corporate existence, has a role in creating mechanisms which foster effective corporate governance. It has been argued that “a good legal environment protects the potential financiers against expropriation by entrepreneurs; it raises their willingness to surrender funds in exchange for securities and hence expands the scope of capital markets.”⁷⁸⁸

3) Responsive Regulation/Smart Regulation:

The principles of responsive and smart regulation are relevant in the development of statutory regulatory regimes especially as the contractual theory promotes self-regulation.⁷⁸⁹ This means that companies would inherently be more accepting of regulation which reflects their needs and peculiarities. Any regulation which does not take cognisance of the architecture of the end users as well as their needs may prove

⁷⁸⁵ See generally the discussions on corporate failures in chapter four.

⁷⁸⁶ See Coglianese et al, (note 539).

⁷⁸⁷ Ibid.

⁷⁸⁸ See R. La Porta, F. Lopez-de-Silanes, A. Shleifer & R. Vishny, ‘Legal Determinants of External Finance’ (1997) 52 *Journal of Finance* 1131 at 1149; see also R. La Porta, F. Lopez-de-Silanes, A. Shleifer & R. Vishny, ‘Law and Finance’ (1998) 106 *Journal of Political Economy* 1113.

⁷⁸⁹ See Ferran, (note 215) 389 where it is stated that market-based regulation is attuned to investor preferences as it is flexible and can be adapted to specific circumstances.

ineffective.⁷⁹⁰ Responsive regulation suggests that the State must regulate in a manner which is in consonant with the recipients of the regulatory measure if a higher level of effectiveness is to be achieved. Smart regulation posits that the State must engage with the peculiarities of the regulated if enhanced effectiveness is to be achieved. The arguments and propositions of Ayres & Braithwaite⁷⁹¹ and Gunningham & Grabosky⁷⁹² are relevant and instructive here because any regulatory measure which is aimed at creating effectiveness within a sphere of activity should take into consideration the principles which are likely to contribute towards the effectiveness of that regulatory measure. Also, it has been argued that it is important for regulation to confer benefits as well.⁷⁹³ A regulatory regime which provides adequate information on the personality risks accruing from the recruitment of directors is likely to be beneficial to the shareholders as well as the public.

The idea of a regulatory intervention is to bring about improvement in the regulated sphere, and so it makes little sense to undertake the regulatory activity from its design to its implementation in a manner which does not ensure its potential effectiveness when deployed to end users. In the UK, the Better Regulation Task Force in 1997 devised the Five Principles of Good Regulation namely: proportionality, accountability, consistency, transparency and targeting.⁷⁹⁴ Therefore, in the development of a regulatory model to address the market failure occasioned by the lack of information about the personality of company directors, and the management of personality risks in corporate governance, it is important to engage with the developmental theories of effective regulatory design and to reflect on those principles in the design of the regulatory model. This way, there are increased chances of acceptability and effectiveness of the model. The model suggested in this thesis has adopted a hybrid approach in order to limit the mandatory provisions to the instances in which those are the most effective option, and allow room for flexibility in necessary areas. In this way, the model engages with the proportionality principle. The model is transparent and accountable as its provisions are clear in purpose and are justifiable. It is consistent and targeted because it is applicable to a specific cadre of

⁷⁹⁰ See Ayres & Braithwaite, (note 178); see also the EU Better Regulation website, (note 204).

⁷⁹¹ See Ayres & Braithwaite, (note 178).

⁷⁹² See Gunningham & Grabosky, (note 203).

⁷⁹³ See Ayres & Braithwaite, (note 178).

⁷⁹⁴ See the Principles at <http://www.berr.gov.uk/whatwedo/bre/> (accessed 15th June 2012).

companies and is directed at solving an identified problem in relation to those companies. Also, effective regulatory principles such as engaging with the regulated and applying levels of sanctions as necessary has been adopted in the development of the model.

6.7 CORPORATE GOVERNANCE AND PERSONALITY RISK MANAGEMENT

The UK Corporate Governance Code 2010 states clearly in its preamble that the purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long term success of the company.⁷⁹⁵ Considering this assertion, it becomes important to evaluate existing corporate governance mechanisms in the light of how successful they are in delivering effective governance. There should be an appropriate balance of all the facets of effective governance aimed at generating sustainable long-term success for the company. It is also imperative to engender a governance ethos which takes cognisance of prudence and effectiveness in the pursuit of entrepreneurial goals, as this is the way in which profit can be generated for shareholders alongside minimising losses for them on the long run.⁷⁹⁶ It is also the way in which the future of a company is reasonably guaranteed for the fulfilment of its societal goals. Companies that are listed on the stock exchange are public companies with numerous shareholders who may not be involved in the management of the companies and may also change over time. For these companies to be managed effectively, the directors should necessarily be persons who are able to do so. In order for the market to be functional, the shareholders need to know what type of company they are investing in, and the company's prospects. Part of the knowledge required is for investors to be able to decide that the management of the company they are investing in is such that is likely to actualise their goals. When information as to the personality of company directors is made available to shareholders, they can decide what type of management team they desire for their company. Shareholders then have the appropriate information as to what type of persons would be more likely to manage their company effectively.

In the event that the shareholders decide that they would rather not select the most appropriate persons to govern their companies, based on the contractual theory, they

⁷⁹⁵ See the UK Corporate Governance Code 2010, p 1.

⁷⁹⁶ See the Revised Turnbull Guidance, (note 170).

should still be able to choose whomever they desire. Shareholders could make their choice of directors based on other considerations which they deem relevant, as well as on the basis of skills, knowledge and experience of the directors, even when the personalities of such directors are not the most appropriate for effective corporate governance. But, in the interests of the general public who may be affected by the activities of a company, the State should mandate shareholders to manage these personalities as risk assets under a clearly defined risk management mechanism. Adopting this option of risk managing persons who are not adjudged to be the most appropriate company directors would help in protecting the shareholders themselves and the society as a whole. Even in cases where shareholders are focused on the short term, there is still a strong case for the company to succeed beyond those shareholders. Therefore, the focus on creating effective management is mostly for the long term success of the company as a facet of the society. In the case of companies with dispersed shareholders listed on the stock exchange, shareholders may come and go, and rightfully so as the goals of shareholders may differ, but the company should be allowed to survive and provide a viable market for future shareholders in addition to fulfilling its goals to its stakeholders, of which the entire society is one.

6.8 AIMS OF THE PERSONALITY RISK MANAGEMENT MODEL

Taking cognisance of what needs to be achieved in the management of personality risks as discussed earlier, which is to identify, assess and mitigate the risks; and considering the indicators of effectiveness; the regulatory model proposed in this thesis aims to achieve the following:

- 1) Provide information regarding the most appropriate personality traits for corporate governance as well as the relationship between personality traits and governance ability

This would enable shareholders to make informed choices as to the level of personality risk they undertake in selecting company directors;

- 2) Identify the personality of company directors

This is the first step in any risk management model and is necessary in the bid to manage personality risks;

3) Provide information on the personality of directors to shareholders and regulators

This is an essential part of the risk management process, in order to aid informed choices of investment in the market and also to facilitate regulatory intervention in cases where it is required;

4) In cases where shareholders decide to elect directors who are not in the category of appropriate persons for governance, the model mandates the company to embark on a personality risk management regime which would help mitigate personality risks;

5) In the long term, the model should help to develop qualifying criteria for company directors based on appropriate personality profiles amongst other relevant factors such as skills, knowledge and experience;⁷⁹⁷ and help to create a corporate governance regime which is more effective, efficient and sustainable.

It is argued that a hybrid regulatory model is the better approach to achieve the aims of the personality risk management model as it takes cognisance of corporate and regulatory theories, and encompasses all the elements which would aid the management of personality risks such as an identification and assessment process as well as risk mitigating processes.⁷⁹⁸ Also, this model recognises the need to enhance effectiveness whilst retaining the flexibility which has been the hallmark of regulation in corporate governance by incorporating mandatory as well as voluntary provisions. The model also stands a high chance of being embraced by the business community and the public as it aims to address the problems of personality risks using regulatory approaches which are viewed as acceptable and justifiable, as well as being adaptable to peculiar circumstances.

6.9 CONCLUSION

This chapter has presented a conceptual framework for the management of personality risks, highlighting the factors that need to be considered. The chapter also suggests possible approaches to achieve this aim, with a discussion on the merits and demerits

⁷⁹⁷ It is argued that over time, shareholders and company directors would come to understand more clearly the kinds of personalities that are best suited to corporate governance. This is because companies might have selected directors based on the appropriateness criteria in relation to personality, and if corporate governance in these companies proves more effective as literature suggests, then that should facilitate more rational decision making in the selection of company directors.

⁷⁹⁸ The justification for selecting a hybrid approach is discussed earlier, and will be discussed in more detail in the next chapter alongside approaches for achieving the aims of the model.

of these approaches. It then indicates a preference for a hybrid regulatory regime as an option which can achieve the aims whilst taking cognisance of corporate and regulatory theories, as well as the need to create effectiveness. Considering corporate and regulatory theories, arguments are then made in justification of a regulatory regime in relation to companies, and further arguments are made regarding the desirability and necessity of such a regime in the management of personality risks in corporate governance. The import of personality risk management in corporate governance is discussed, in support of the justification for regulatory intervention. The chapter then discusses the aims of the model with a view to enhancing an understanding of the provisions of the model as would be outlined in the next chapter. In the development of this model, regard has been had to the theories discussed in this and previous chapters, as well as current realities in relation to the regulation of companies. The next chapter presents the suggested model in detail, discussing possible approaches to achieving the aims of the model, limitations in present corporate governance regimes, details of the hybrid approach suggested, specific provisions in the model, and other relevant considerations in relation to the suggested model.

CHAPTER SEVEN

THE MODEL

7.1 PRELIMINARY ISSUES

In this section, the aim is to examine present corporate governance mechanisms in order to determine the extent to which they address the problems associated with personality risks. The public listed companies operating within the UK are governed by the provisions of the Companies Act 2006, the UK Corporate Governance Code, and Directors Disqualification Act 1986. Companies operating in the financial services sector are regulated by the Financial Services Authority. The EU directives on company law will also be discussed, as the UK is an EU jurisdiction, and these directives form part of UK corporate law. These regulatory mechanisms will be examined with illustrations as to their inadequacies with regard to managing personality risks, and the issues considered are the extent to which these mechanisms identify company directors with high risk personalities, if the information in relation to personality is provided to the markets, and whether effective personality risk management processes are developed to mitigate identified personality risks.

7.1.1 REVIEW OF EXISTING MECHANISMS

The following table illustrates the extent to which existing corporate governance mechanisms address the issue of personality risks in corporate governance.

Table 1

LAW/REGULATION/ CODE	APPLICABILITY	PROVISIONS WHICH MANAGE PERSONALITY RISKS	LIMITATIONS
UK Companies Act 2006	All companies	<p>-None as regards initial evaluation of company directors to determine personality</p> <p>-Age limit specified under section 157</p> <p>-Directors' Duties under sections 171-177, particularly section 172 aimed at influencing the behaviour of directors</p> <p>-Directors' accounting and reporting functions for example in sections 386-414 and sections 415-436</p> <p>-Provisions relating to shareholders/members influence for example in sections 160, 188, 197, 439, 476</p>	<p>There is no initial evaluation requirement for company directors under the Act.</p> <p>Shareholders are free to appoint whosoever they choose to act as a director subject only to the age requirement.</p> <p>As regards mitigating personality risks by influencing the behaviour of a director, the consequences outlined in the Act for breach of duties and reporting provisions only sets in after the harm has been done, and therefore only mitigates personality risks to the extent that the provisions act as deterrence, and this may not be so in some cases.</p> <p>The requirement under section 172 is particularly subjective and the duties of directors generally require the presence of</p>

			<p>persons who are dutiful, otherwise, there is still the risk of disobedience of the duties under the Act.⁷⁹⁹</p> <p>Where the consequence of acting contrary to the provisions of the Act is the imposition of fines as in the example of section 414, if the gains of disobedience outweigh the losses of fines, there is still a risk that deterrence would not be achieved.⁸⁰⁰</p>
UK Corporate Governance Code	All companies listed on the London Stock Exchange	<p>-Nominations Committee functions under Provision B.2</p> <p>-Evaluation provisions under Provision B.6</p> <p>-Risk management and internal control provisions under Provision C.2</p> <p>-Audit Committee and Auditor functions</p>	<p>There is no specific provision for personality assessment at the point of recruitment of directors.</p> <p>The Nominations Committee focus is on the balance of skills, knowledge and experience required by the board of directors.</p> <p>Evaluation provisions are post recruitment and</p>

⁷⁹⁹ See Fisher, (note 245); see also Okoye, (note 419); see also Christopher et al, (note 380).

⁸⁰⁰ See Brammertz, (note 302); see also Wilson & Hernstein, (note 303); see also note 711.

		under Provision C.3	<p>mostly undertaken as internal self-assessment by the directors.</p> <p>The available provisions are not mandatory, as the code is applied on a “comply or explain” basis, leaving room for discretion and thereby creating an inherent risk of non-compliance.</p> <p>If personality risk is not mitigated from the onset, then the procedures put in place for risk management, internal control and audit have a higher possibility of being circumvented and the entire governance system becomes prone to failure.</p>
Company Directors’ Disqualification Act 1986	All Companies	-Sections 1-9 and particularly section 6 relating to unfit directors	<p>Becomes operative after the damage has been done.</p> <p>The provisions are mostly invoked when a company is already insolvent.</p> <p>The provisions can act mostly as a deterrent, but considering the theories of personality, persons who are not prone to compliance</p>

			might not be deterred by rules or consequences, especially where the gains of non-compliance outweigh the losses.
The Financial Services Management Act (FSMA) 2000 & FSA's Approved Persons Regime	Companies in the financial services sector	<p>-Section 59 providing that no person may perform controlled functions except on approval by the FSA</p> <p>-Sections 61, 63, 66 empowering the FSA to administer the "fit and proper" regime</p> <p>-The FSA's Statements of Principle and Code of Practice for Approved Persons (APER) & The Fit and Proper test for Approved Persons (FIT) Provisions</p>	<p>Applies only to companies operating in the financial services sector.</p> <p>Information derived from the evaluation process is not mandatorily made available to the shareholders. Only available in FSA Register.</p> <p>Deals with aspects of personality such as honesty and integrity in retrospect, but not personality profile in its entirety proactively as it relates to governance and leadership potential and ability.</p>

EU DIRECTIVES ON COMPANY LAW AND CORPORATE GOVERNANCE

In relation to company law and corporate governance, an important objective as indicated by the EU is to provide adequate protection for shareholders and the public who are invariably potential shareholders as well and to foster efficiency and competitiveness in business operations within Europe.⁸⁰¹ There are no EU directives which deal directly with the issue of evaluating company directors at the point of recruitment whether as a means of mitigating personality risks in corporate governance or otherwise. Directive 2003/58/EC which deals with disclosure requirements in respect of certain types of companies only contributes to making already mandated information available to the shareholders.⁸⁰² Therefore, if there is no mandatory requirement for the identification of personality dimensions amongst boards of directors, and the disclosure of information relating thereto, the directive is unlikely to be effective in making that piece of information available to shareholders. Directive 2006/43/EC relates to qualifications for statutory auditors and audit firms, and the requirement for public entities to have audit committees and establish risk management processes.⁸⁰³ Directive 2006/46/EC requires listed companies to include a corporate governance statement in their annual report which should include a description of the company's risk management and internal control processes.⁸⁰⁴ There are also recommendations on the role of audit committees and disclosure requirements in relation to corporate risks.⁸⁰⁵ These directives highlight the importance of risk management in companies even though there is no direct focus on the management of personality risks.

In the Report of the Reflection Group on the Future of EU Company Law published in April 2011,⁸⁰⁶ it was stated that an argument against introducing risk management devices is that

⁸⁰¹ See the EC Website http://ec.europa.eu/internal_market/company/index_en.htm (accessed 15th June 2012).

⁸⁰² See EU Council Directive 2003/58/EC of 15 July 2003 amending Council Directive 68/151/EEC as regards disclosure requirements in respect of certain types of companies [2003] OJ L 221/13.

⁸⁰³ See EU Council Directive 2006/43/EC of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC [2006] OJ L 157/87.

⁸⁰⁴ See EU Council Directive 2006/46/EC, (note 350).

⁸⁰⁵ See EC Recommendation 2005/162/EC of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board [2005] OJ L 52/51; see also Council Directive 2004/109/EC of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Council Directive 2001/34/EC [2004] OJ L 390/38.

⁸⁰⁶ See the Report in the EC Website http://ec.europa.eu/internal_market/company/docs/modern/reflectiongroup_report_en.pdf (accessed 15th June 2012).

viable companies have a market incentive to engage in all cost effective risk control devices both formal and informal, and so to impose a legal duty to adopt such devices, and as a consequence restricting them to formal and verifiable ones, is unjustified for listed companies.⁸⁰⁷ However, contrary to this argument, it was also highlighted in the report that as much as controlling shareholders would possess an interest in the long term success and viability of their company, market forces did nothing to prevent the financial crisis of the recent years and proved inadequate in ensuring effective risk management.⁸⁰⁸ The report also indicates that whilst there is no absolute guarantee that increased risk management and risk disclosures would produce better governance, it is hoped that they contribute towards this end.⁸⁰⁹ One reason to agree that increased risk management and disclosure through the imposition of regulatory requirements is necessary is because the markets which had operated largely on a voluntary basis proved inadequate in preventing corporate failures,⁸¹⁰ and therefore, it becomes appropriate to institute regulation in order to redress the inadequacies of the market.⁸¹¹ The report indicates that it is still a valid notion that public listed companies warrant regulation because their shareholders are usually dispersed and subject to frequent change, and traditional agency problems exist.⁸¹² Therefore, regulation which addresses the problems surrounding the issue of companies having dispersed shareholders is relevant and justified.⁸¹³

Again, controlling shareholders might have an incentive to ensure the long term success of their companies, but, the same might not be said of dispersed non-controlling shareholders who might only be interested in the short term results of their investments.⁸¹⁴ These short-term focused shareholders may not be engaged in the operations of the market in ways that ensure effective management of the companies they have invested in, because their interest is likely to be on profit maximisation and they might be too dispersed to be influential.⁸¹⁵ These companies nevertheless need to be effectively managed for the good of others far and beyond the shareholders.⁸¹⁶ Therefore, regulation which is aimed at improving the effective

⁸⁰⁷ Ibid at p 40.

⁸⁰⁸ Ibid.

⁸⁰⁹ Ibid.

⁸¹⁰ Ibid

⁸¹¹ See Ferran, (note 215).

⁸¹² See the report, (note 806), at p 10.

⁸¹³ Ibid.

⁸¹⁴ See Dine, (note 49), see also Webb et al, (note 58).

⁸¹⁵ Ibid.

⁸¹⁶ See Freeman, Wicks & Parmar, (note 77) 364-366; see also Letza, Sun & Kirkbride, (note 67) 250; see also Donaldson & Preston, (note 77) 65-91.

management of public listed companies is essential. Aside from cost effectiveness as an economic principle of business, and the quest to improve efficiency by limiting processes, the institution of risk management processes in areas where risks have remained unmanaged can contribute to higher levels of effective risk management in companies. Therefore, a risk management process which takes cognisance of issues such as cost and efficiency, whilst still improving the entire risk management atmosphere in a company, should be embraced if overall effective risk management is to be achieved. Again, there are situations where the benefits of a mechanism developed to create improvement in a process out-weigh the cost of its deployment, and in such cases as is the one envisaged by the suggested model which is aimed at preventing corporate failures, the issue of cost should become less material.⁸¹⁷ Also, overall enhancement in efficiency in the long term is important and should override any inconvenience which results as part of taking on an additional improvement process.

7.1.2 POSSIBLE APPROACHES TO ACHIEVING THE AIMS OF THE MODEL

A pertinent issue that arises is as regards approaches through which the aims of the regulatory model can be actualized and the arguments made here are in favour of incorporating both mandatory mechanisms and soft law mechanisms into the model. The next table outlines possible approaches for addressing the issue of personality risk management with an indication as to persons responsible, the cost implications and the limitations of each approach. The reasons for choosing the particular approach adopted in the model are then discussed.

⁸¹⁷ See the UK Better Regulation Executive (BRE) Annual Review 2009 *Striking the Right Balance* at <http://www.bis.gov.uk/assets/biscore/better-regulation/docs/10-578-striking-the-right-balance-bre-annual-review-2009.pdf> p 20 (accessed 15th June 2012) where it is stated that each regulation is intended to deliver benefits and though there is a price attached, well-designed regulation will always have a positive net impact for society.

Table 2

APPROACH FOR MANAGING PERSONALITY RISKS	MECHANISM	RESPONSIBILITY & COST	LIMITATIONS & CONCERNS
NO LAW Companies are allowed to recruit whosoever they choose as directors, without any personality evaluation. (The status quo)	Existing company law provisions and corporate governance code principles as well as company internal recruitment processes.	Directors, Shareholders, Market for corporate control. No additional cost implications because no new requirement is introduced.	Personality risks remain unidentified and unmitigated, with grave implications for corporate success and failure; and possibility of negative impact on society.
SOFT LAW Personality evaluation is propagated as a principle of best practice, and evaluators are recommended. Companies decide whether or not to adopt the recruitment evaluation process. Disclosure of findings of the evaluation exercise is also	Recommendations and principles are embedded in corporate governance codes or other voluntary mechanism such as the Turnbull Guidance. Personality evaluation for directors and necessary disclosures forms part of the functions to be carried out by the nominations committee, or any other body responsible for	Directors, Shareholders and Market for corporate control-same as all other code provisions. Cost is borne when companies decide to take on the evaluation exercise using the recommended evaluators. Additional disclosure costs may be borne in cases where the company decides to disclose the	Because the provisions and recommendations are voluntary, personality risks remain inherently unidentified and unmitigated, thereby reducing the overall effectiveness of the provisions. The “comply or explain” basis of codes such as the UK code means that the provisions may not be complied with.

<p>recommended as a principle of best practice.</p> <p>Recommendations are made as to processes for managing high risk directors.</p> <p>Companies decide whether or not to adopt the recommendations.</p>	<p>recruiting company directors.</p> <p>Managing high risk directors forms part of mechanisms such as the company's Enterprise Risk Management process.</p>	<p>findings of the evaluation exercise and to manage the high risk company directors in the recommended manner or any other adequate manner.</p>	<p>Discretion in the voluntary nature of soft law provisions leads to varying standards across board, which defeats the aim of risk management.</p> <p>When companies decide not to comply with any or all of the recommendations, knowledge gap in the market as to the personality of directors still exists. Even if companies disclose non-compliance, that still does not disclose the personality of directors.</p>
<p>MIX OF SOFT LAW AND HARD LAW-“HYBRID”</p> <p>Companies are mandated to undertake the personality evaluation process in order to identify the personality of company</p>	<p>Mandatory provisions may originate as amendments to the Companies Act or a new statutory instrument.</p> <p>Voluntary recommendations may</p>	<p>Directors, Shareholders, Market for corporate control.</p> <p>External Authority which ensures the objectivity of the evaluation process; receives and evaluates</p>	<p>Additional requirements for company management.</p> <p>Cost implications.</p> <p>Where companies decide to take</p>

<p>directors, thereby identifying potential risks.</p> <p>Companies may then voluntarily choose to recruit whosoever they wish as a director.</p> <p>Companies are mandated to make the necessary disclosures.</p> <p>Companies are mandated to manage high risk directors using the recommended processes or any other which achieves the same purpose and render reports on the process.</p>	<p>become additional provisions in corporate governance codes or other regulation.</p>	<p>reports and monitors compliance.</p> <p>Costs to be borne by companies for the process, same as is the case for registration and reporting obligations.</p> <p>Costs to be borne by the external authority for the process.</p>	<p>on high risk directors and not to adopt the recommended risk management mechanism, external authority has to ensure that company's own risk management processes are adequate.</p> <p>Creating amendments to existing company law provisions and corporate governance codes.</p> <p>Burden of promulgating new statutory regulations or codes.</p> <p>Acceptability of the mandatory provisions by corporate leaders.</p>
<p>HARD LAW</p> <p>Companies are mandated to undertake personality evaluation of company directors.</p>	<p>Provisions embedded in Companies Act as amendments or in any other statutory regulation.</p>	<p>Directors, Shareholders and External Authority.</p> <p>Costs to be borne by company and external authority for the process.</p>	<p>Excludes potential directors who might be high risk but possess other essential characteristics required for company management.</p>

<p>Companies are mandated to recruit only company directors who are low risk.</p> <p>Companies are mandated to manage high risk directors using mandatory provisions.</p>			<p>Exert pressure on companies to recruit only directors who are low risk as well as possessing all the other essential requirements for effective company management.</p> <p>Practically goes against the contractual theory of the corporation under which company owners reserve the right to appoint company managers.</p> <p>Inflexible, ignoring the potential for effective personality risk management.</p> <p>Ignoring the one size does not fit all principle as regards mandatory provisions for managing personality risks.</p>
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			<p>Higher cost implications.</p> <p>Additional requirements for company management.</p> <p>Acceptability of mandatory rules by corporate leaders.</p> <p>Burden of promulgating new statutory regulations.</p>
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7.1.3 JUSTIFICATION FOR A HYBRID APPROACH

The model proposed in this thesis is a hybrid approach to regulation; a mix of soft law by way of recommendations and hard law by way of mandatory provisions. The reasons for adopting this approach are highlighted in chapter 6, section 6.3, but they are also discussed in greater detail below, particularly in relation to the provisions suggested for inclusion in the model.

1) Regulatory theories:

An examination of the dominant regulatory theories as discussed in previous chapters evidences support for the argument that regulatory provisions which adhere to the principles of responsive and smart regulation are most likely to be effective.⁸¹⁸ The rationale behind the suggested regulatory model is to utilise hard law in cases where that is the only option which is most likely to engage with the problem appropriately, and in this case, the identification of the personalities of directors, disclosures to shareholders and regulators, and developing a personality risk management process require the adoption of hard law as that is the most effective means of managing those aspects of personality risks.⁸¹⁹ These issues are the primary bases of the personality risk problem in relation to public listed companies. If these issues are left in the arena of soft law, the associated discretion and the voluntariness would defeat the aims of the entire regulatory process and leave personality risks inherently unmitigated because there will be a possibility that companies may choose not to comply with the recommendations. The history of corporate failures evidence the effects of ignoring personality risks and the potential adverse consequences of continuing to do so for public listed companies specifically is the fundamental reason for the arguments in this thesis in support of hard law where necessary, particularly as regards awareness and identification of personality risks. Then, considering the contractual theory of companies, shareholders are still allowed to select the directors of their companies, but the model ensures that they do so with the full knowledge of the risks they undertake.⁸²⁰ Also, this approach of allowing shareholders make their selection of company directors recognises the acceptability of soft law approaches in corporate governance, and the importance of engendering the spirit

⁸¹⁸ See Ayres & Braithwaite, (note 178); see also Baldwin & Cave, (note 186); see also Gunningham & Grabosky, (note 203).

⁸¹⁹ See Fuller, (note 724); see also Gunningham & Grabosky, *ibid.*

⁸²⁰ The contractual theory argues that company managers are agents of the shareholders, see Jensen & Meckling, (note 29); see generally the discussions on corporate theories in chapter two, section 2.2.

of self-regulation which has been argued as an element that ensures better co-operation from regulated companies.⁸²¹ Mandating the identification of directors, and then allowing the company the discretion of making its choice based on the disclosed piece of information regarding the personality of directors is an approach which balances regulation in the public interest and the contractual theory of the corporation.

Responsive regulation argues that the regulator engages with the peculiarities of the regulated,⁸²² and arguments have also been made that regulation is more effective when a regulator has a relationship with the regulated and offers a degree of discretion.⁸²³ A degree of discretion is essential in this case because a company is formed by its members, the shareholders, even though the public have a peculiar interest in companies whose activities affect the populace. Smart regulation principles as propounded by Gunningham and Grabosky also indicate that the adoption of a mixture of regulatory instruments, applying the least interventionist measure to achieve the aim and creating regulatory pyramids, are essential for the creation of effective regulation.⁸²⁴ Taking account of these principles, the indicative hybrid approach proposes a mixture of hard law and soft law, the hard law being applied in specific areas as the least necessary measure to obtain an effective result at mitigating personality risks. Soft law approaches are then adopted for the areas in which the aim of personality risk mitigation can be achieved through various means and the least interventionist method is proposed. The hybrid model provides specific recommendations in relation to managing personality risks, as well as the option for companies to adopt internal or other procedures which would achieve the same objectives. The reason for this approach is that personality risk management would differ from company to company, depending on the peculiarities of the companies, and so, flexibility is required in order to engender effectiveness.⁸²⁵

The hybrid model proposes the utilisation of an external authority as regulators in the risk management process, in order to ensure objectivity and standardisation.⁸²⁶ It is suggested

⁸²¹ See Ayres & Braithwaite, (note 178).

⁸²² Ibid.

⁸²³ See Dine, (note 49).

⁸²⁴ See Gunningham & Grabosky, (note 203).

⁸²⁵ This would be one reason why corporate governance codes are developed as soft law mechanisms, because one size might not fit all companies. See the UK Corporate Governance Code 2010, p 2 & 4, which provides that boards have a lot of room within the framework of the Code to make decisions and that there are instances where departure from the provisions of the code would be justifiable if good governance can be achieved by other means.

⁸²⁶ The external authority is discussed in more detail later in section 7.2.5.

that this authority will monitor compliance with the regulatory provisions, and intervene where necessary in order to secure compliance. The external authority will adopt the principle of regulatory pyramids and interventions will be graduated depending on the levels of non-compliance. The provisions of the model operate on the basis that where the personalities of directors have been identified, the essential risk is considered identified. This has to be a mandatory exercise because if it is not carried out, there is nothing to evidence the personality of directors and the risk remains unidentified and the question of risk management would not even arise. If shareholders already have the appropriate information regarding the personality of directors, then the foundational risk has been identified; and it seems appropriate to allow some level of discretion in the actual selection of directors based on the fact that the shareholders would now be presumed to be in a better position to make rational choices in this regard; and in the selection of personality risk management processes which suit the company's needs, subject to the minimum standards recommended by the model.

According to the provisions of the suggested model, in relation to selecting directors, two mechanisms come into operation. First, there is a mandatory mechanism which ensures the disclosure of the information regarding the personality dimensions of the prospective directors to shareholders. This mechanism has to be mandatory because disclosing the information is essential for the market and is also a risk management exercise to the extent that it allows shareholders decide whether they want their companies to be managed by high or low risk directors, thereby identifying the risks they are undertaking. There is no option of a voluntary mechanism in this situation because if the disclosure is not made, the risk is left unidentified. There is either an obligation to disclose or an option not to disclose. In the cases where directors are selected by the nominations committee, the information regarding the personality of prospective directors is disclosed to that committee for the same purposes. The shareholders are subsequently provided with the same information at the point of ratification of the directors' appointments.⁸²⁷ Second, there is the mandatory mechanism of adopting a personality risk management process. Here, the aim of the mechanism is to manage the already identified personality risk. The company is mandated to manage the personality risk, but the actual risk management process can be undertaken in various ways. That is why a soft law approach

⁸²⁷ See s 160 of the UK Companies Act 2006 which provides that shareholders are required to vote on the appointment of directors of public companies.

is essential. It aids and supports the possibilities of managing the risks in the best possible way suited to individual companies. The most appropriate regulatory method is then a soft law one with recommendations and the option of departing from the recommended provisions in the case that another approach would achieve the same aim. This would be consistent with the “comply or explain” mechanism of the UK Corporate Governance Code.

2) Current Trends:

Under the contractual theory of the company upon which companies in the UK are historically founded, the State is not expected to intervene in the regulation of companies except to the extent that regulation is needed for the effective functioning of the market.⁸²⁸ Therefore, recommendations for the adoption of hard law in this regulatory model have been restricted to those aspects of personality risk management which are most essential for the effective functioning of the market, for instance the mandatory identification of personality risks, the disclosure of information to the market, and the risk management of high risk company directors. Based on Cheffins’s definition of the perfect market as one in which actors “act rationally, are numerous, have full information about the products on offer, can contract at little cost, have sufficient financial resources to transact, can enter and leave the market with little difficulty, and will carry out the obligations which they agree to perform”,⁸²⁹ it becomes evident that statutory regulation is desirable for the purposes outlined above as a means of regularising an imperfect market. This is because it is important that market participants have adequate information regarding the risks which accrue from the personality of company directors, and also to evaluate whether the directors are persons who are capable of carrying out the obligations which they agree to perform. Again, it is essential that corporate failures and associated financial losses are prevented so that there will be sufficient financial resources available for transactions in the market. These are issues which have not been addressed sufficiently by existing mechanisms and contribute to imperfections in the market. In keeping with the tenets of soft law in the regulation of companies, voluntary recommendations are proposed in the areas in which discretion can be allowed with minimal adverse effects on the market. Therefore, adopting hard law in the most critical

⁸²⁸ See Du Plessis, (note 50) 48; see also Ferran, (note 215); see also Hood et al, (note 779).

⁸²⁹ See Cheffins, (note 375).

areas where conformity is essential and retaining soft law in the areas where flexibility is required is an optimal regulatory approach which accords with present day realities.

An example of the current thinking in this regard is reflected in the efforts being made by the European Commission to ensure that regulation is smart and better. In the communication from the European Commission on Smart Regulation in the European Union issued on 8th October 2010, some salient and pertinent issues were highlighted.⁸³⁰ There was a reiteration of the importance of markets as sources for the deliverance of sustainable prosperity for “ALL” (emphasis mine).⁸³¹ Again, the communication stated that markets would not always be able to deliver this purpose on their own and therefore regulation has a positive and necessary role to play.⁸³² However, the crux of the communication is that regulation must be better by being smart.⁸³³ In another document on better regulation, it was stated that in an era of globalisation, citizens expect their governments to ensure their safety and welfare, and businesses expect public authorities to ensure a level playing field and boost competitiveness; and regulation is key to meeting these challenges.⁸³⁴ Public administration needs to be effective, flexible and focused; and better regulation is one of Europe’s core priorities.⁸³⁵ It is these principles of effectiveness, flexibility and focus that have informed the choice of a hybrid regulatory approach in addressing the problems associated with the personality risks of company directors. The European Commission acknowledges the possibility of different regulatory instruments and the use of self-regulation and co-regulation in cases where those approaches would be more effective.⁸³⁶ As regards the suggested model, the choice to regulate is borne out of the importance of regulation in addressing the anomalies within the market considering how the operations of the market impacts on the citizenry, and the method of regulation is influenced by the need to take cognisance of the form of regulation that is most likely to achieve the desired aim. Also, aligning regulatory

⁸³⁰ See The Communication Document at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0543:FIN:EN:PDF> (accessed 15th June 2012).

⁸³¹ Ibid, p 2.

⁸³² Ibid.

⁸³³ Ibid, p 2-3. The communication indicates that smart regulation means ensuring the highest quality possible across the whole policy cycle from design to implementation, enforcement, evaluation and revision.

⁸³⁴ See the Better Regulation Document at http://ec.europa.eu/governance/better_regulation/documents/brochure/br_brochure_en.pdf, at p 3 (accessed 15th June 2012).

⁸³⁵ Ibid, preface by Jose Manuel Barroso, President of the European Commission.

⁸³⁶ See the EU website http://ec.europa.eu/governance/better_regulation/instruments_en.htm (accessed 15th June 2012).

methods with currently acceptable approaches to regulation is a means of engendering effectiveness and sustainability, because the issues that are viewed as acceptable in the development of effective regulation are taken into consideration.

3) Cost:

Regulation can generate costs, and these costs are a real concern to companies especially in a challenging economic climate.⁸³⁷ A company is an economic entity and the issue of regulatory costs is a pertinent one.⁸³⁸ Regulation is often viewed as a barrier, consuming valuable time and money, and taking company directors away from the primary task of running companies.⁸³⁹ Striking the right balance between the benefits that regulation delivers to society and the costs it imposes on businesses is vital to ensure a healthy economy.⁸⁴⁰ Achieving the right balance means adopting a level of regulation that promotes competition and stability without impinging on companies' ability to operate.⁸⁴¹ It is therefore important to avoid unnecessarily burdensome regulation.⁸⁴² The idea of adopting a hybrid mechanism accords with the tenets of achieving the regulatory aims at the least cost to the companies and to the State. It has been argued that regulation is never cost-free, both for the regulated and the State, and so the pertinent issue is delivering effective regulation at the least cost.⁸⁴³ Ayres & Braithwaite argue that the State should only regulate when it is the cheapest option of addressing the issue at hand.⁸⁴⁴

A hybrid approach ensures that the cost of statutory regulation is incurred only in the areas in which it is absolutely necessary to utilise hard law, and self-regulatory mechanisms are adopted where they can achieve the aims of the regulation, thereby contributing towards cost reduction for the regulated entities and the State. The mandatory provisions in the suggested model are proposed as such because that regulatory approach is the least required to actually achieve the desired purpose and outcome. Providing necessary information and disclosure, and leaving the room for

⁸³⁷ See the UK Better Regulation Executive (BRE) Annual Review 2009, (note 817) p 3 & 21.

⁸³⁸ See Ribstein, (note 248).

⁸³⁹ See the UK Better Regulation Executive (BRE) Annual Review 2009, (note 817) p 5.

⁸⁴⁰ See the UK Better Regulation Executive (BRE) Annual Review 2009, (note 817) p 28.

⁸⁴¹ See the HM Treasury Report *Reducing Regulation Made Simple*

<http://www.bis.gov.uk/assets/biscore/better-regulation/docs/r/10-1155-reducing-regulation-made-simple.pdf> section 1 (accessed 15th June 2012).

⁸⁴² Ibid.

⁸⁴³ Ibid, section 3.

⁸⁴⁴ See Ayres & Braithwaite, (note 178) 103.

actors in the market to use their initiative in undertaking and managing personality risks is intended to be an efficient regulatory combination. Again, smart regulation is about regulating in cases where it is absolutely necessary to do so whilst keeping costs at a minimum.⁸⁴⁵ Therefore, the suggested model takes cognisance of economic realities and presents the option of internal self-regulation in the areas where there exists the possibility of that approach being effective in achieving both its specific aim and the overall objective of the regulatory mechanism. Under the provisions of the model, companies would have the option of applying the cheapest available approach which would meet the regulatory objectives.

⁸⁴⁵ This was stated in the EU Better Regulation website
http://ec.europa.eu/governance/better_regulation/index_en.htm (accessed 15th June 2012).

7.1.4 THE HYBRID APPROACH

The regulatory approach adopted in this model combines hard law provisions and soft law provisions as follows:

Table 3

	PROVISIONS	RESPONSIBILITY
HARD LAW	Identification of personality dimensions of directors	Shareholders, Directors, External Authority
	Disclosure of personality of directors selected	Shareholders, Directors and External Authority
	Risk management of high risk directors	Directors and External Authority
SOFT LAW	Selection of directors based on information on personality risks	Shareholders and Directors
	Risk management of high risk directors using recommended or other adequate provisions	Directors and External Authority

The sphere of activities is illustrated in the following diagram:

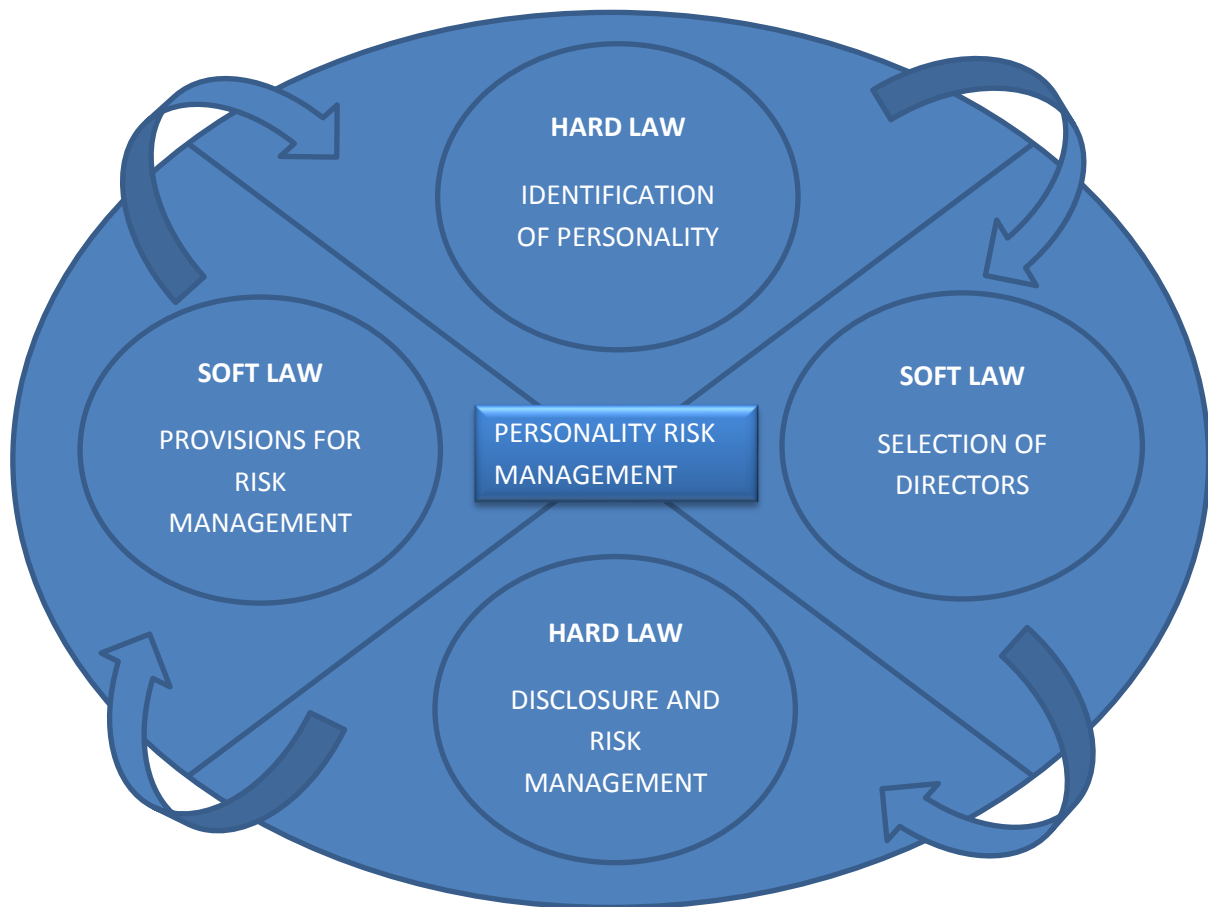


Figure 2 above illustrates the flow of hard law and soft law provisions in the personality risk management cycle.

7.2 THE MODEL IN DETAIL

7.2.1 APPLICABILITY

The regulatory model presented in this thesis is applicable to company directors. These are the persons charged with the management of companies on behalf of its shareholders and these shareholders may or may not be on the board of directors.⁸⁴⁶ The UK Companies Act 2006 reiterates the position of directors as managers of companies.⁸⁴⁷ There is no distinction

⁸⁴⁶ See Formoy, (note 87); see also O'Donnell, (note 87); see also Gevurtz, (note 87) 925.

⁸⁴⁷ See s 20, UK Companies Act 2006; see also Art 3 of the Model Articles for private limited companies and public companies. It is also noteworthy that in the UK, both non-executive directors and executive directors have the same legal duties, see A. Belcher & T. Naruich, 'The Evolution of Business Knowledge in the Context of Unitary and Two-Tier Board Structures' (2005) *Journal of Business Law* 443-472 at 470.

made in this model between executive and non-executive directors because the UK Companies Act 2006 does not recognise such a distinction even though in the UK Corporate Governance Code there is an elucidation of different roles for both categories of directors.⁸⁴⁸ The main issue which the model aims to address is the risk associated with the personality of these persons who make decisions and act on behalf of companies, and the associated mitigation of these risks by ensuring that the persons who manage companies are in the best position to contribute to effective governance within companies. The objective of the model is to provide information which will enable informed choices as regards the selection of individuals with the most appropriate personalities to engage in corporate governance, and also to enable the management of the risks associated with the selection of persons who are not the most appropriate personalities for engagement in corporate governance functions. A succinct explanation of the role of company directors in corporate governance is summed up in Para 2.5 of the Cadbury Code and replicated in the UK Corporate Governance Code 2010 which states as follows:

Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting.

This provision demonstrates the importance of the directorship function and illustrates the key role of the directors in being responsible for the success or failure of a company. Consistent with this position, it is important to ensure that company directors are persons who are capable of fulfilling their role.⁸⁴⁹ Although management executives also act on behalf of the company, the core of corporate governance activities is that the directors supervise the management team and set the strategic direction of the company.⁸⁵⁰ The

⁸⁴⁸ See the UK Corporate Governance Code 2010, Principle A.4 which indicates that the role of non-executive directors is that of oversight, scrutiny and contribution to strategy in respect of company operations.

⁸⁴⁹ See the discussions in chapter five which indicate that some personality dimensions are better suited to corporate governance than others.

⁸⁵⁰ See the UK Corporate Governance Code 2010, A.1 Supporting Principle.

management team are expected to develop the strategies already set by the directors and make decisions around those strategies. Therefore, if the directors are persons who are capable of making appropriate decisions and taking appropriate actions, then, it can be expected that company management should fall into similar tendencies.⁸⁵¹ As discussed earlier, the recruitment process for company directors is not usually as formal as that for other company employees, and so there are higher risks of recruiting inappropriate persons as directors.⁸⁵² Under existing corporate governance recommendations, the nominations committee deal with the recruitment of directors, and there are no specific requirements for personality assessments.⁸⁵³ The directors are the uppermost cadre of corporate officers, and have no higher level of supervision within the company. In the interest of cost implications and necessity, a personality risk management mechanism for company directors is the more important element and a good starting point in the management of personality risks in companies as a whole.

Company directors are the group of company managers recognised by law under the Companies Act as evidenced in provisions such as those relating to the requirement of a company to have directors and directors' duties to the company.⁸⁵⁴ Again, the shareholders appoint the directors, but do not necessarily appoint the management team.⁸⁵⁵ Article 5 of the UK Model Articles of Association grants the power of delegation to directors, and so they may delegate their duties and powers to management executives. However, the primary responsibility of company management rests with company directors and it is for all the reasons above that this model of personality risk management in companies is applicable to company directors. There is no doubt that considering the fact that personality affects behaviour across all levels of roles, a valid argument exists in support of applying personality risk management processes to all the participants in the corporate governance process, including the regulators, in order to ensure the effectiveness of the entire process.

⁸⁵¹ See Hofmann & Jones, (note 692); see also Harrison et al, (note 692); see also Stewart, (note 693); see also Moynihan & Peterson, (note 694).

⁸⁵² See Cadbury, (note 225); see also Dulewicz & Herbert, (note 224). Personality tests are often utilised in employee selection in companies and has demonstrated predictive validity across a variety of occupational groups and performance criteria, see S.D. Risavy & P.A. Hausdorf, 'Personality Testing in Personnel Selection: Adverse Impact and Differential Hiring Rates' (2011) 19(1) *International Journal of Selection and Assessment* 18-30.

⁸⁵³ See the UK Corporate Governance Code 2010, Provisions B.2.1 and B.2.2.

⁸⁵⁴ See s 154-156 and s 171-177 of the UK Companies Act 2006.

⁸⁵⁵ The shareholders appoint the first directors and company secretary as specified under s 12 (1) of the UK Companies Act. The directors may make subsequent appointments based on the powers delegated to them by the shareholders.

However, in particular relation to managing personality risks as it concerns the governance of companies, the directors are the most important persons as they engage with the actual risks and processes which can result in corporate failures. Other participants, such as the regulators are not involved in the actual processes of governance, so their personality risks in relation to the governance of companies is minimised.

7.2.2 TIMING

The process should commence at the point of recruitment with an evaluation process which identifies the personality of directors. Directors could be appointed as first directors of a company by its shareholders or subsequently by the existing board of directors subject to the approval of the shareholders, but in any case, the evaluation of the director's personality dimension should be undertaken at the point of selection of that director. The model is applicable to public listed companies,⁸⁵⁶ and so for a new company, the provisions come into effect at the point of listing.⁸⁵⁷ There should be a requirement for a disclosure statement to be included in the listing particulars to the effect that the provisions of the regulatory model have been complied with in relation to the company directors, and indicating the level of personality risk ascribed to each director. The UK Listing Rules in section 6.F.2 already mandates the disclosure of information relating to issues such as unspent convictions, disqualifications and bankruptcies. Information relating to personality risk is one which can be argued to fall into similar categories, because it gives an indication as to the director's potential behaviour in corporate governance. The underlying reason for requesting information such as those mandated by the listing rules is so as to identify potential risks, because the existence of such situations indicates the potential for certain behavioural tendencies. It is in the same manner that the evaluation of directors in relation to their personality indicates the potential for certain behaviours, although they may not have occurred.⁸⁵⁸

⁸⁵⁶ See the discussions on the scope of the research undertaken in chapter one, p 5-7. The problem which the thesis addresses originates in the functioning of public listed companies, and the regulatory model suggested in response to the problem is targeted at the same type of companies because there is a justification for State interference in the governance of such companies on account of market failures and in the interests of the public. Again, the shareholders of public listed companies are usually dispersed and the companies essentially trade with public funds.

⁸⁵⁷ A public company may decide not to be listed, see the UK Listing Rules s 1.4 which refers to application for listing.

⁸⁵⁸ As argued in chapter five, behaviour is the outward evidence of personality as personality is the inward evidence of behaviour, see Hartmann, (note 542).

7.2.3 PROCEDURE

The suggested procedure for the application of the model is as follows:

- 1) The State should issue a document containing the following elements:
 - a) The different personality dimensions and the requisite personality dimensions most appropriate for effective corporate governance: Based on personality research and psychological analysis, a comprehensive and authoritative document can be drawn up on the different personality dimensions and their influences on behaviour as it concerns corporate governance. This document would be made available to shareholders and they would be advised to study it as part of their preparations in setting up a new public listed company and investing in an already existing one.
 - b) A list of requirements for acceptability of personality evaluators in the case that the State decides not to be the sole personality evaluator for companies: The State could decide to establish a regulatory authority (the external authority) to deal with the evaluation of directors for reasons such as maintaining similar standards across all companies, ensuring objectivity, independence and enhancing effective supervision of the entire process. On another hand, if the prospects of a sole authority as evaluator will affect the expediency of the process, the State could establish certain standards and requirements, such as the criteria for determining objectivity and expertise, which if met by any private evaluator can enable that evaluator undertake personality evaluation of directors and issue acceptable results. The salient issue is that these evaluators have to meet the requirements set down by the State. It would be important for both the external authority and private evaluators to have adequate resources which would enable the attainment of appropriate standards in the evaluation process. Again, in consideration of data protection and privacy issues, the State could restrict the accreditation for the conduct of evaluation processes to a limited number of evaluators.
 - c) A list of accredited private evaluators in the case that the State decides to publish the list of evaluators whose services must be used by the companies: This approach may be necessary in order to clarify and

streamline the activities of personality evaluators and provide companies an easier access to appropriate evaluators. Here, the State would have undertaken the responsibility of ensuring that the accredited evaluators have met the minimum requirements and standards. An example of this process can be seen in the requirement for companies to utilise the services of particular accounting firms who are accredited for audit purposes. In the case that private evaluators are utilised, their reports should be sent to the external authority which is the regulatory authority for the model. The external authority subsequently makes the information available to the relevant parties.⁸⁵⁹

- 2) The prospective directors of a public listed company are evaluated in relation to their personality dimensions: Based on the personality traits which are adjudged as most suitable for corporate governance, a selection criteria can be derived which would determine the level between low risk and high risk at which a director can be placed depending on the results of the evaluation exercise.
- 3) Shareholders of a company are allowed to select directors:
 - a) If selected directors fall under the category of personalities most suited to corporate governance (low risk directors), the normal governance principles and corporate law regulations continue to apply and the company need not embark on a personality risk management process.
 - b) If selected directors fall under the category of personalities not suited to corporate governance (high risk directors), the mandatory risk management requirement of the model becomes operational in respect of those directors. The shareholders or directors are also required to explain their choice of high risk directors with justifications for such selections. The purpose of this provision would be to help address their minds to the risks they are undertaking and reassure themselves of the necessity to assume such risks.

⁸⁵⁹ These parties are the shareholders as company owners and selectors, directors as company managers and selectors, and the stock exchange as the regulators of the market. The external authority represents the State and the society in the regulatory process.

- c) Shareholders would be provided with information regarding the most appropriate personality dimensions for corporate governance and it is assumed that they would make rational choices in the selection of directors. It would be more rational to select directors who are low risk because they would be more capable of appropriate behaviours. However, for the reason that shareholders have the prerogative under the contractual theory to choose the managers of their company, they should have the choice to select anyone irrespective of his/her personality dimension. Again, for purposes of flexibility, persons who are considered high risk should be accommodated in the governance process if they have some positive contributions to make, the only caveat being that the risks accruing from them must be managed effectively in order to prevent corporate failures. This flexibility is also necessary in consideration of the fact that the risk issue in question is based on the potential of a director to behave inappropriately and as indicated in psychology literature, personality might not be conclusive proof in absolute terms regarding the prospective behaviour of an individual. However, it should be noted that in the case that shareholders decide to select high risk directors, and depending on the balance between low risk and high risk directors, it would necessitate an increased involvement of shareholders in the governance process because they would have a stake in ensuring that these personality risks are managed. This is not necessarily a negative situation because shareholders ought to be as involved as possible in the management of their companies.⁸⁶⁰
- d) Where directors have made subsequent appointments to the board, at the point of ratifying such appointments, shareholders should be provided with information regarding the personality dimensions of the directors.
- 4) Disclosure of information on the personality of directors selected: Information regarding the personality risk level ascribed to a director should be disclosed to the external authority which is to act as the regulatory authority for the process. The

⁸⁶⁰ See the UK Stewardship Code for Institutional Investors 2010, Principle 3 which provides that investors should monitor companies and seek to satisfy themselves to the extent possible that the investee company's board and committee structures are effective.

shareholders would then be provided with the information to aid the selection of directors. The directors would also have access to the information to enable effective risk management and in the case of subsequent appointments. The information would be disclosed to the Stock Exchange as part of listing requirement and as they are regulators of the stock market. The annual reports and other publicly available corporate governance reports made by the company should state simply that the company has complied with the provisions of the regulatory model. The reason for this is so as to comply with the principles of data protection and privacy rules which would be discussed in detail in subsequent sections and which specify that personal data should be processed only to the extent necessary to achieve the purpose for which it is intended. Annual reports can be accessed by the world at large in this era of internet publications, and so there is a need to ensure that information made available there is for public consumption, and does not contravene individual privacy rights. Essentially, the information regarding the personality of directors is most relevant to, and should be made available to the regulator as representatives of the State and society, the shareholders as owners of the company and appointees of directors, the board of directors as managers of the company, and the Stock Exchange as regulators of the market.

- 5) The State through the external authority should provide recommendations on how best to manage personality risks in a general framework: Considering that one size may not fit all, and different companies would be involved in different spheres of operations and activities, the companies should be allowed to either adopt the baseline recommended personality risk management framework, or develop a framework of their own which would achieve the same purpose. In the case that the company elects to use its own framework, details of this should be made available to the external authority in order to ensure its efficacy. The State should provide a document or statement containing minimum standards of reasonable personality risk management which the companies have to adhere to in the case that the companies chose not to adopt the recommended framework for personality risk management. The company should adopt a personality risk management framework at the point in which it selects a high risk director.

7.2.4 MONITORING AND REPORTS

Reports should be made to the external authority upon the recruitment of any new director stating as follows:

- 1) That the personality evaluation process has been complied with.
- 2) That the shareholders or directors have completed the selection of directors after studying the document on the most appropriate personality dimensions for corporate governance.
- 3) The personality dimensions of the selected directors and the balance of personality risks across the board.
- 4) In the case of high risk directors, that the company has agreed to adopt the recommended personality risk management framework, or
- 5) That the company will manage the high risk director under its own choice of risk management procedure, and
- 6) Details of the risk management framework which the company has chosen to adopt.

7.2.5 THE EXTERNAL AUTHORITY

In order for regulation to be effective, it has to be enforceable. This thesis suggests the use of an external authority backed by law as the regulator for the model so as to ensure the objectivity of the process and also to act as a legitimate source for the enforcement of the mandatory statutory provisions. An example of an evaluation mechanism in the UK which utilises an external authority is the FSA's Approved Persons Regime, backed by the FSMA 2000 and applied by the Financial Services Authority. The independence of the authority from companies it regulates no doubt contributes to the effectiveness of its framework of regulation.⁸⁶¹ A government established authority would be expected to be more devoid of capitalist motives, in the case that the State is focused on ensuring that companies are governed effectively, and would be best positioned to ensure fairness, equality and appropriate standards for a process of evaluation such as the one proposed in this model. The

⁸⁶¹ See Dewing & Russel, (note 148).

Registrar of Companies in the UK and the Prudential Regulatory Authority⁸⁶² are examples of external authorities that could be used as the regulator for the model. In their principles of smart regulation, Gunningham & Grabosky highlight the need to engage interested second and third parties in the regulatory process.⁸⁶³ They argue that the State can create efficiency by involving parties who are interested in the regulatory outcome to act as surrogate regulators. Therefore, institutions such as the Stock Exchange should be involved in the regulatory process because as regulators of the market, they have an interest in ensuring that companies are governed effectively.

Other establishments such as the Institute of Directors could also be utilised in the actualisation of the purposes of the model because as the professional body which provides service and support to company directors, they should be interested in ensuring that company directors are effective in their roles. The challenges of such surrogate regulators however would be that there has to be an enabling law which provides the institution with the authority to act in place of the State, and issues of objectivity, adequate resources and independence would also have to be dealt with and met. In any case, as it relates to this model, the important factor is the establishment of an authority independent from the companies which would be effective in actualising the objectives of the regulatory model by enforcing the mandatory provisions and overseeing the application of the self-regulatory provisions. As regards funding, it is suggested that companies will pay a fee for the evaluation process, and both the State and companies would contribute towards the administrative and operational costs of the external authority. The reason behind this is that companies and the State have stakes in the actualisation of the purposes of the model, and there should be financial commitments from both parties. The pattern of companies funding the functions of regulatory authorities can be gleaned from the FSA which charges annual fees from regulated companies. As with the funding of the FSA, it is suggested that companies make annual fee payments for the regulatory

⁸⁶² The Prudential Regulatory Authority (PRA) is the authority which will take over the regulatory functions of the FSA in relation to companies operating in the financial services sector. The FSA do not receive funding from the government and charge fees to all the firms that they regulate as well as other bodies such as investment exchanges, see the FSA website <http://www.fsa.gov.uk/about/who/funded> (accessed 15th June 2012).

⁸⁶³ See Gunningham & Grabosky, (note 203).

functions of the external authority in the suggested model. Another relevant example in which companies are made to fund the regulatory activities of regulators is as regards Environment Agencies which are allowed under section 42 of the Environmental Act 1995 to set up charging schemes for their functions and issuance of licences.

However, the State has also been involved in funding regulatory authorities, even for new legislative issues, as is evident under section 24 of the Gangmasters (Licensing) Act 2004 which provides that the Secretary of State may make financial provisions to the Gangmasters Licensing Authority. This means that the Authority is essentially funded by the State even though it can charge for its functions such as the issuance of licences, but, all monies realised from these regulatory charges are paid to the Secretary of State. In this scenario, the State contributes to the funding of the Authority. The Gangmasters Licensing Authority was created under the 2004 Act in response to the death of Chinese immigrant workers in the Morecambe Bay cockling disaster. The Act aims to regulate the functioning of recruitment agencies for workers in the agricultural sector in order to safeguard the rights and well-being of the workers, a cause which is in the public interest. The effective functioning of public listed companies and the prevention of corporate failures is essential for a healthy economy and the provision of goods and services. There are also positive social implications for well-governed companies such as the availability of jobs and the boost of capitalism. This is beneficial to society as a whole, and contributions to regulation which enhances these prospects is a worthy investment for a State in the public interest. It might be the case that the companies and shareholders who are the direct causes of the regulatory intervention and recipients of the regulatory benefits would have to contribute more, but, it is necessary that the State contributes as well in order to ensure the sustainability of the regulatory process and lessen the financial burden of the regulation on companies.

7.2.6 RECOMMENDED PROVISIONS FOR INCLUSION IN THE MODEL

The model would present recommended provisions for personality risk management. Some of the issues which would be important to include in such a recommendation are as follows:

- 1) Management of high risk directors under the company's Enterprise Risk Management framework:

Enterprise Risk Management (ERM) has emerged and developed as a new paradigm designed to increase boards' and senior management's ability to manage the portfolio of risks facing an enterprise.⁸⁶⁴ It differs from traditional risk management techniques in which risks are managed individually, and instead uses a holistic top down approach to manage risks across an enterprise.⁸⁶⁵ ERM is essentially the identification and assessment of the collective risks that affect firm value and the implementation of a firm-wide strategy to manage those risks.⁸⁶⁶ The rapid proliferation of ERM is driven by provisions in corporate governance codes, stock exchange rules and legislation which have been interpreted as requiring an increased need for the management of risks beyond the fundamental financial risks (examples include the UK Corporate Governance Code Principles C.2.1 and C.3.2; the NYSE Corporate Governance Rules 2004; Sarbanes-Oxley Act [2002] Section 409). ERM is focused on a correlation between risk management and strategy in an enterprise-wide structure.

In an effort to give some flesh to the ERM drive, in September 2004, the Committee of Sponsoring Organisations of the Treadway Commission (COSO) issued an integrated framework to provide a model for ERM. That framework defines ERM as "a process effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the

⁸⁶⁴ See M.S. Beasley, R. Clune & D.R. Hermanson, 'Enterprise Risk Management: An Empirical Analysis of Factors Associated with the Extent of Implementation' (2005) 24 *Journal of Accounting & Public Policy* 521-531.

⁸⁶⁵ See A.E. Kleffner, R.B. Lee & B. McGannon, 'The Effect of Corporate Governance on the Use of Enterprise Risk Management: Evidence from Canada' (2003) 6(1) *Risk Management and Insurance Review* 53-73.

⁸⁶⁶ See Meulbroek, (note 174).

entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives”.⁸⁶⁷ As much as the COSO Framework was tested with selected companies, there is still limited practical knowledge about the intricacies of an ERM infrastructure, but one salient issue is the fact that it is a tool used to elevate risk discussions to strategic levels.⁸⁶⁸ ERM is well established in larger organisations such as companies in the banking and insurance sectors where there is a link to asset risk management and actuarial research, but in some other sectors, ERM is still in the early stages of development and implementation.⁸⁶⁹ Also, due to non-existent or ineffective risk management processes, non-financial risks have not been viewed as priority in some boardrooms.⁸⁷⁰ However, there is a need for companies to embrace the principles of ERM because many corporate failures have arisen due to the traditional methods of managing risk in silos, causing important risk elements to escape management attention in situations where for instance unacceptable risk parameters may exist in component parts even when the whole of the firm is functioning on a comfortable risk balance.⁸⁷¹

The numerous benefits of ERM include reducing inefficiencies originating from a lack of coordination between various risk management departments; saving costs due to a concentration of risk management efforts; optimizing resource allocation strategy and improving capital efficiency as a result of prior knowledge of risk outcomes; and improvement of transparency because firms can better inform outsiders of their risk profile, which is a signal of their commitment to risk management, thereby reducing the costs and efforts of regulatory scrutiny.⁸⁷² Considering all that ERM seeks to achieve and its benefits, there would be increased effectiveness if the personality risks

⁸⁶⁷ See The COSO Framework 2004, (note 175).

⁸⁶⁸ See The Conference Board 2005, (note 173).

⁸⁶⁹ See I. Brown, A. Steen & J. Foreman, ‘Risk Management in Corporate Governance: A Review and Proposal’ (2009) 17(5) *Corporate Governance: An International Review* 546-558.

⁸⁷⁰ See Meulbroek, (note 174).

⁸⁷¹ See Drew & Kendrick, (note 166).

⁸⁷² See R. Hoyt & A. Liebenberg, ‘The Value of Enterprise Risk Management: Evidence from the U.S. Insurance Industry’ (2006) *University of Georgia Working Paper* <http://ssrn.com/abstract=1440947> (accessed 15th June 2012).

associated with directors were also managed as a risk category under a company's ERM framework. This way, the personality risk portfolio would constantly be on the board's agenda as a strategic issue, and the risk analysis, risk management discussion and decisions would be undertaken at the level of top management, thereby giving it the attention and seriousness it deserves. Also, in order to save cost, reports of personality risk management can be rendered alongside reports on the entire ERM framework, instead of generating separate reports on personality risk management. Again, investors and interested parties can analyse the risk management processes of the company in a single framework, making it faster and easier to make decisions concerning the risk management potential and procedures in a particular company. The COSO Framework defines risk as "the possibility that an event will occur and adversely affect the achievement of [entity] objectives".⁸⁷³ Clearly, having directors who are inappropriate personalities in corporate governance is a risk because it has the inherent possibility of adversely affecting the achievement of corporate objectives to the extent that those directors have the potential to make decisions and take actions which would be detrimental to the success of the company. Since ERM seeks to manage all the possible corporate risks, personality risks should naturally be incorporated into the ERM framework.

- 2) Enshrining specific provisions which would be aimed at mitigating personality risks of high risk directors, examples include the following:
 - a) Vetting of all major transactions of high risk directors by shareholders: In the case that shareholders have selected high risk directors, then the shareholders would have to vet their major decisions, and this would entail more shareholder involvement in the management of companies. It might be the case that shareholders in certain situations might not be knowledgeable and experienced enough to take on this task, so an option that would be open to them is to have recourse to experts who can vet the decisions on their behalf. This might result in cost implications and time wasting, and appear to negate the whole idea of having company directors,

⁸⁷³ See COSO Framework 2004, (note 175) 4.

but, it is an essential task in the management of high risk directors. Ordinarily, shareholders are required to vet and approve certain actions and decisions of directors under company law, so paying particular attention to the transactions undertaken by high risk directors might result in added responsibilities for the shareholders.⁸⁷⁴ The UK Listing Rules under Sec 10 provides a classification of transactions and specifies as Class 1 any transaction with a percentage ratio relative to the company of 25% or more. Under section 10.37, the directors are required to issue an explanatory circular to shareholders and obtain their prior approval in respect of such transactions. It is suggested that in cases like this, there should be an added disclosure on such a circular indicating the balance of personality risks on the board so as to address the minds of shareholders as to the potential risks and enable them to consider enhancing their level of scrutiny over such transactions if need be;

- b) Preventing high risk directors from being chair persons of committees so as to reduce the possibility of such directors exercising overriding powers. In the case that it becomes inevitable that a high risk director must chair a committee, then there should be increased scrutiny by shareholders on the activities of that committee;
- c) Ensuring that high risk directors are up for re-election on an annual basis so as to give shareholders the opportunity as often as possible to review their performance and make changes if desired;
- d) Taking account of the influence of leadership on collective behaviour, it would be advisable to recommend that the board chairman is a low risk director so as to set the appropriate tone for the entire governance process;
- e) Regular evaluation of the performance of high risk directors by the external authority: this can be achieved by analysing the reports rendered by companies and requesting specific information on the activities of high risk directors where necessary;
- f) Specifying that a company in which all the directors or a majority of them are high risk directors should not be allowed as a director of yet another public company;

⁸⁷⁴ See for example the UK Companies Act 2006 s 190 in relation to substantial property transactions and s 197 in relation to loans to directors.

- g) Requiring companies with a majority of directors in the high risk category to submit quarterly accounts in cases where they would have submitted only half-yearly and annual accounts;⁸⁷⁵
 - h) Requiring companies with high risk directors to submit intermittent reports to the external authority stating that they are complying with personality risk management procedures. One aim of this provision would be to constantly address the minds of the directors as to the potential risks existing within the corporate governance process. Also, the directors should include a declaration undertaken by them stating that they agree to be personally liable in the event that it is discovered that the company is not complying with the agreed personality risk management process;
 - i) Ensuring that internal control measures take adequate cognisance of personality risks in framing control measures aimed at the management of corporate risks across the company;
 - j) Setting a financial threshold above which an individual high risk director cannot go in his dealings in committing the company.
- 3) Recommendations as to reasonable standards of personality risk management: In cases where a company decides to use its own internally developed personality risk management procedure or adopt an externally developed one other than the one recommended by the model, it would be important to create minimum standards and ensure that all companies are adhering to procedures which are reasonably acceptable and adequate to manage personality risks. Therefore, even though companies are allowed to select the procedure they wish to use, it is important for the procedure to be in accordance with certain minimum standards and these standards can be specified in the model. Companies can then develop their own risk management procedure from the minimum standards and customize the procedure in line with the peculiarities of the company. The directors are responsible for risk management in companies, and so they must also manage the risks accruing from their personalities. In the case that other officers and auditors are involved in some of the risk management processes, the essential strategic risk management

⁸⁷⁵ The UK Listing Rules s 12.41 and s 12.46 provide that listed companies must issue half-yearly and annual reports.

framework adopted by the directors would usually set the tone for the management of all other risks including operational and compliance risks.

- 4) Requirements for reports to be issued in cases of corporate failures, which indicate the personality dimensions of the directors and the specific personality risk management processes utilised by the company. This is to enable a review of the effectiveness of the model in the long term and facilitate the development of improved processes in relation to personality risk management.

7.2.7 THE RISK MANAGEMENT PYRAMID

This model envisages a graduated level of response to the engagement of companies in the personality risk management exercise by the external authority. The pyramid of processes is illustrated below:

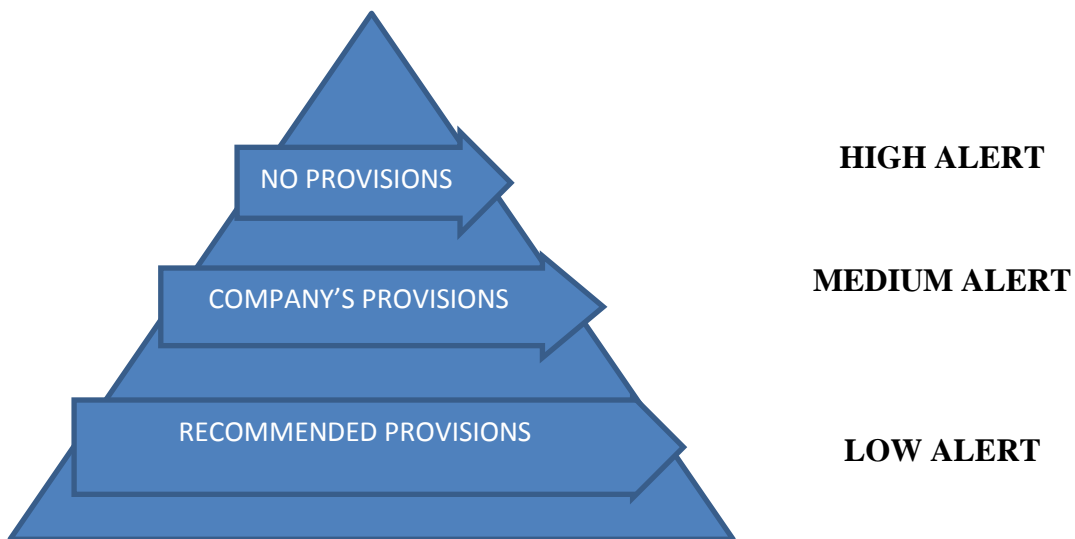


Figure 3 above shows the levels of responses

In instances where a company adopts the recommended framework for risk management, the monitoring function of the external authority is easier because there will be no need to analyse and ensure the efficacy of the procedure. If the company elects to adopt its own framework either internally developed or transplanted from another external entity, the external authority would have to ensure that it is fit for the purpose of personality risk management and once this is ascertained, the monitoring

function continues. Should a company decide not to adopt a personality risk management framework, it contravenes the mandatory provisions of the regulatory model, and the external authority would have to apply sanctions to elicit compliance.

7.2.8 SANCTIONS

The existence of a strong incentive to comply with regulatory provisions is a key element in any regime aimed at deterring unacceptable behaviour. Regardless of the type of enforcement mechanism employed as regards corporate governance regulations, be it subtle or forceful, the overall effectiveness of such enforcement mechanisms definitely contributes to the sustenance and enhancement of that regulatory regime. In 2005, Sir Phillip Hampton undertook a review of the UK regulatory system and made recommendations seeking to achieve a regulatory system which was risk-based, consistent, proportionate and effective.⁸⁷⁶ Some of the proposals in the final report which are of the most relevance here are as follows:

- 1) Reducing regulatory inspections where risks are low but increasing them where risks are high. The risk management pyramid above supports this principle;
- 2) Applying the use of advice. The use of recommendations in this model is a form of advice to companies on the best mode of achieving the aims of the regulatory model;
- 3) Applying tougher and more consistent penalties where necessary. The use of a mix of soft law and hard law in this model helps to achieve this aim;
- 4) Requiring new policies and regulations to consider enforcement using existing structures wherever possible. The suggestion to utilise authorities such as the PRA and institutions such as the stock exchange is in keeping with such recommendations.

In 2006, the UK government also commissioned a report from Professor Richard Macrory which sought to address issues on improving regulatory compliance amongst

⁸⁷⁶ See the Hampton Report *Reducing Administrative Burdens: Effective Inspection and Enforcement*, HM Treasury March 2005 at <http://www.berr.gov.uk/files/file22988.pdf>; (accessed 15th June 2012); see also the BIS website <http://www.bis.gov.uk/policies/better-regulation/improving-regulatory-delivery/assessing-our-regulatory-system> (accessed 15th June 2012).

UK businesses.⁸⁷⁷ The Macrory Report examined the main reasons for non-compliance and recommended improvement mechanisms. The recommendations were primarily aimed at ensuring that regulators had a set of modern and flexible sanctions to apply in the enforcement of regulation.⁸⁷⁸ These sanctions needed to be proportionate and appropriate to the regulatory risk in question.⁸⁷⁹ In the Macrory review consultation document, it was noted as follows:

*Sanctions are an important part of achieving compliance in supporting the enforcement activities of regulators. In some instances, the threat of a punishment can act as a catalyst towards improved outcomes and greater compliance. It can do this by providing a signal to the firm that has offended (and others who are contemplating offending) that the offence will not be tolerated and that there will be a reprimand or consequence. Other times, the imposition of a sanction can provide a non-compliant firm with an opportunity to better understand what is required of it under the law and improve the firm's competence and performance, as well as ensuring better compliance with regulatory obligations.*⁸⁸⁰

Macrory noted that a heavy reliance on criminal sanctions for regulatory offences can lead to *compliance deficit* originating from a regulator's reluctance to pursue non-compliance due to the expense and time required to do so.⁸⁸¹ He also stated that criminal sanctions may be disproportionate to the offence and may not address the needs of the victims.⁸⁸² He suggested principles for effective sanctions which were also noted in the final report as follows:⁸⁸³

⁸⁷⁷ See the Macrory Report *Regulatory Justice: Making Sanctions Effective* at <http://www.bis.gov.uk/files/file44593.pdf>; (accessed 15th June 2012); see also the BIS website <http://www.bis.gov.uk/policies/better-regulation/reviewing-regulation/improving-compliance-among-businesses> (accessed 15th June 2012).

⁸⁷⁸ See the Macrory Report, *ibid*, at p 7.

⁸⁷⁹ *Ibid*.

⁸⁸⁰ See the consultation document *Regulatory Justice: Sanctioning in a post-Hampton World* at <http://www.bis.gov.uk/files/file44582.pdf> 11 (accessed 15th June 2012).

⁸⁸¹ See the consultation document, *ibid* 15; see also the Macrory Report, (note 877) 23-24.

⁸⁸² See the consultation document, *ibid*; see also the Macrory Report, (note 877) 16.

⁸⁸³ See the consultation document, *ibid* 19-20; see also the Macrory Report, (note 877) 10.

- 1) Sanctions should aim to change behaviour;
- 2) Sanctions should aim to prevent financial gains from non-compliance;
- 3) Sanctions should be responsive taking cognisance of what is appropriate for each offence and each offender;
- 4) Sanctions should be proportionate to the nature of the offence and the harm caused;
- 5) Sanctions should include an element of restoration;
- 6) Sanctions should aim to deter future non-compliance.

The Macrory Report stated that administrative sanctions should be employed widely and recommended options such as fixed and variable monetary penalties, cessation notices, stop notices, discretionary requirements, enforcement undertakings etc. and also recommended the publication of enforcement activities on a regular basis.⁸⁸⁴

The recommendations made by the Hampton and Macrory reviews were incorporated in the Regulatory Enforcement and Sanctions Act 2008 which deals with the establishment of the local better regulation office, reduction and removal of regulatory burdens and creation of civil sanctions for regulatory offences amongst other issues.⁸⁸⁵ In the consultation on the draft Regulatory Enforcement and Sanctions Bill, the Minister for the Cabinet Office particularly noted that the way in which regulation is enforced can make a major difference to businesses and society.⁸⁸⁶ Although the Act deals mostly with local authorities, the provisions encompass the principles of better regulation and are relevant examples of avenues for achieving effective enforcement and sanctioning in regulatory regimes. In regard to levels of sanctions, the UK Planning Act 2008 is instructive as it makes provision for information notices and enforcement notices.⁸⁸⁷ Information notices are issued in order to provide information regarding a breach of the provisions of the Act. Enforcement notices require an offender to take steps as specified under the notice to remedy a breach of the provisions of the Act and must specify the time period within which the required steps are to be taken.

⁸⁸⁴ See the Macrory Report, (note 877) 36-85; see also the BIS website <http://www.bis.gov.uk/policies/better-regulation/reviewing-regulation/improving-compliance-among-businesses> (accessed 15th June 2012).

⁸⁸⁵ See the Act at http://www.legislation.gov.uk/ukpga/2008/13/pdfs/ukpga_20080013_en.pdf (accessed 15th June 2012).

⁸⁸⁶ See the Foreword by Hilary Armstrong at <http://www.bis.gov.uk/files/file44594.pdf> (accessed 15th June 2012).

⁸⁸⁷ See s 167 and s 169 of the UK Planning Act 2008.

The sanctions proposed for non-compliance with the model suggested in this thesis is consistent with the principles outlined above, taking cognisance of the need to minimise cost and maximise effectiveness. The reports highlighted above all illustrate the need for sanctions in order to enhance effectiveness of a regulatory regime and the salient issue then is the manner of sanctions to be employed. Suggested approaches are as follows:

1) NOTICES:

The external authority can issue written notices of non-compliance with the provisions of the regulatory model where such breaches come to its attention. The notice would state the matters which constitute non-compliance, what actions need to be undertaken by the company in regularising the cases of non-compliance, and the time frame within which it is required to do so. This approach is similar to that undertaken in planning law in relation to enforcement notices.⁸⁸⁸ Section 172 of the UK Town and Country Planning Act 1990 provides that a local planning authority may issue an enforcement notice where it appears to it that there has been a breach of planning control. Section 173 of the same Act provides that an enforcement notice shall state the matters which constitute the breach of the planning control, and specify the steps which the authority requires to be taken in order to remedy the breach and the time period within which such steps are to be taken. The UK Planning Act 2008 also supports this approach in its section 169 (4) & (5) which deal with notices of unauthorised development. Another example of support for this approach can be seen in section 156 of the UK Companies Act 2006 in relation to breaches of sections 154 & 155 under which the Secretary of State may give the defaulting company a direction specifying the breached statutory provision, what the company is required to do and the period within which it must do it. In relation to the suggested model, if a company fails to undertake the mandatory personality evaluation of its directors or fails to institute a risk management process for high risk directors, an enforcement notice can be issued which specifies that the company has breached the provisions of the model and is required to comply with these provisions within a specific time period. If the company complies with the provisions of the regulatory model and the

⁸⁸⁸ See V. Moore & M. Purdue, *A Practical Approach to Planning Law* (12th ed., Oxford: Oxford University Press 2012) 393-402.

external authority is so notified, the enforcement process ends at that stage. If, however, there is continued non-compliance, the regulator can then issue a further notice stating its intention to apply other sanctions available to it and that the directors would not be recognised as such and should cease to act on behalf of the company until the provisions of the regulatory model are complied with. It is recommended that notices should be the first available sanction as they also serve to inform and advise the company of the regulatory provision, thereby providing a basis, depending on the company's response, from which to ascertain the company's willingness to comply with the regulatory provisions. This knowledge is essential for the purposes of responsive regulation and applying appropriate graduated sanctions.

2) FINES:

Negative financial implications can operate as an effective form of sanction, but there are also limitations in this regard. One of the findings of the Hampton Review was the inadequacy of monetary penalties as deterrent to regulatory non-compliance, and the fact that fines do not often reflect the economic implications of non-compliance with regulatory provisions.⁸⁸⁹ For example, if a regulatory provision specifies that companies must meet certain requirements for an operating licence and compliance with the regulation would cost the company £1,000 annually, if the company does not comply with the regulation in a year, it has saved £1,000. If a fine is prescribed for non-compliance, any amount less than £1,000 may not be adequate to deter non-compliance because a company may prefer to default and pay the fine and still save money against compliance costs. Inappropriate financial penalties could be viewed as acceptable risk by companies that have chosen to be deliberately non-compliant.⁸⁹⁰ Therefore, in relation to securing compliance through the imposition of fines, it becomes important that fines are such as to give rise to negative financial implications for the company or defaulting corporate officers. In some cases, fines do not also reflect the harm done to society.⁸⁹¹ To be meaningful as a form of sanction, fines should be reflective of the nature of non-compliance. In the model suggested in this thesis, there should be a requirement for a company which defaults in undertaking the evaluation process, rendering reports on the evaluation process or adopting a

⁸⁸⁹ See the Hampton Report, (note 876) 6.

⁸⁹⁰ See the Macrory Report, (note 877) 20.

⁸⁹¹ Ibid.

personality risk management process to be fined an appropriate and optimal sum. In addition, and in order to secure personal liability, there should also be a provision for the defaulting directors to be fined in their personal capacity.⁸⁹² So, for instance, the members of a nomination committee who select directors without adhering to the provisions of the regulatory model would be fined. Again, it is recommended that fines should not take the place of specific performance. The company and directors should still be required to comply with the regulatory provisions even after the payment of the fines.

3) DISQUALIFICATION:

In a case where a company director/s fail to comply with the provisions of the regulation and after notices and fines have been issued, the external authority should be able to prosecute such a director/s and there should be provisions for a disqualification order to be made against the defaulting director/s. The reasoning behind this sanction is that a director who cannot comply with regulatory requirements is not fit to be a director as company management is predominantly an exercise in complying with regulatory requirements established to ensure effectiveness in corporate governance.⁸⁹³ If such a defaulting director is disqualified, then there is no opportunity for that director to be selected as a director by any other company, and so the risk of that director flouting the regulation again would be mitigated. Also, if all the directors of a company are disqualified under this provision, as would be the case if the responsibility for recruiting directors rests on the board as a whole, then the shareholders would have to appoint new directors and the possibility of the regulation being flouted subsequently should be minimised if the shareholders consider the drawbacks and costs of making new selections and ensure that the nomination committee abide by the regulatory provisions. The regulatory model suggested in this thesis aims at advising companies to select the most appropriate directors for the delivery of effective corporate governance, and mandates the companies to manage the personality risks of directors who are high-risk, but does

⁸⁹² This approach is also recommended in the UK Listing Rules for breach of its provisions, (see s 1.8 & 1.9) http://www.fsa.gov.uk/pubs/other/listing_rules.pdf (accessed 15th June 2012).

⁸⁹³ See the UK Corporate Governance Code 2010 p 1 which provides that the purpose of corporate governance is to facilitate effective and prudent management of the company. See also the Revised Turnbull Guidance 2005 para 19 which provides that internal control is concerned with managing risks in order to ensure the attainment of corporate objectives.

not ordinarily aim to disqualify any persons from company management. However, in the case that company directors persistently fail to comply with the provisions of the model, disqualification orders would be appropriate. This provision is based on the fact that directors are empowered to appoint subsequent directors, after the initial appointment of the first company directors by the shareholders. Directors are also the persons who are to engage with the personality risk management processes.

4) PUBLICITY AND DE-LISTING:

The Macrory Report recommended that enforcement efforts should be publicized on a regular basis.⁸⁹⁴ This is in the interests of the regulatory regime as the regulated entity would have sufficient information on the application of sanctions to non-compliant entities and this should serve as evidence that non-compliance would not be tolerated by the regulator. Likewise, in the proposed model, the regulator can undertake to publicize information on companies that are failing to comply with the regulation and the sanctions levelled against such companies. This form of publicity can aid the regulatory regime to the extent that intending investors know which companies are complying and they can also influence compliance in a deviant company perhaps as a condition for investment. This process of publicity can also invariably aid the market for corporate control as shareholders can make better informed decisions when they have appropriate information regarding a company's activities. Compliance with regulatory requirements is an important aspect of corporate governance,⁸⁹⁵ and shareholders can act on information provided by regulators in their publicity. This is similar to the effect of the "comply or explain" principle of the UK Corporate Governance Code, because the shareholders are expected to make judgments as to the position and effectiveness of a company based on information regarding if and how the company has complied with the code and the explanations for non-compliance.⁸⁹⁶ Peer pressure and pressure from shareholders and prospective investors may then serve as a form of deterrent as well as a force to secure compliance with the regulatory provisions. This approach is used by regulatory models such as the FSA's

⁸⁹⁴ See the Macrory Report, (note 877) 91.

⁸⁹⁵ See the Revised Turnbull Guidance para 19 which provides that internal control should encompass processes for managing compliance risks.

⁸⁹⁶ See the FRC Report *The UK Approach to Corporate Governance*, November 2006 at <http://www.frc.org.uk/documents/pagemanager/frc/FRC%20The%20Uk%20Approach%20to%20Corporate%20Governance%20final.pdf> p 5-7 (accessed 15th June 2012).

regime which publicises its enforcement efforts and results.⁸⁹⁷ The reputation of a company should be an asset to it and so the threat of any form of negative publicity may serve to secure compliance.

In the extreme scenario that a company refuses to comply with the provisions of the regulation and continues to default after all other sanctions have been applied, it is recommended that such a company should be delisted.⁸⁹⁸ The provisions of the regulation are aimed amongst other issues at protecting the public from corporate mishaps as a result of having high-risk directors on the boards of public companies. Private companies face similar personality risks no doubt, but the financial implications and negative results of the corporate failure of a privately owned company would not have the same public and societal impact as the failure of a publicly owned listed company.⁸⁹⁹ One of the major justifications for regulatory intervention in the identification and management of personality risks for directors of public companies is the fact that public companies trade with public funds and their failure results in the loss of public funds amongst other negative implications. The general public who are potential investors in public companies ought to be protected by the government and this regulatory model is one way to achieve that purpose. If a company decides not to comply with the proposed regulatory provisions, then that company should lose the right to trade with public funds and can carry on its business with private funds and abide by regulations applicable to a private company.

5) REQUIREMENT FOR LISTING:

For new companies, the model should specify the requirement to comply with its provisions as part of listing procedures. This would ensure that all new public listed companies comply with the relevant regulatory provisions or risk the refusal to be listed to trade on the stock exchange. As with the provisions of section 9 of the UK

⁸⁹⁷ See the FSA website <http://www.fsa.gov.uk/about/media> (accessed 15th June 2012).

⁸⁹⁸ Naming and Shaming, as well as Delisting are also options open to the Stock Exchange for non-compliance with listing rules. See the UK Listing Rules, (see s 1.8, 1.9, 1.15 & 1.19).

⁸⁹⁹ There are some large private companies such as Alliance Boots, John Lewis Partnership, Virgin Atlantic and Aramark, however, these companies' shares are held by a limited number of people, usually family members, employees or private partnerships. The failure of these companies would be grave in terms of losses to their limited number of shareholders and the services that the companies provide, but, the failure of public listed companies will have a far reaching impact as the shareholders of such companies are usually much more in number and are dispersed. Again, public listed companies trade with funds obtained from the public and so they require increased accountability and scrutiny from the public.

Companies Act 2006, for instance, which deals with the documents which must be submitted in an application for registration of a company, there could also be a requirement stating that a statement of compliance with the provisions of the regulatory model must be submitted to the listing authority. The directors of the company should also be required to sign statutory declarations in this regard for which they would be made personally liable in cases of non-compliance.⁹⁰⁰ The statutory declaration is aimed at securing the personal liability of directors as essentially the regulators would be in a position to know when a default has occurred because companies will be monitored to ensure that they are complying with the regulatory provisions.

It is noteworthy that Macrory stated in relation to his principles for effective sanctions that fundamental to these ‘penalties principles’ is the notion that the underlying regulation is fit for purpose and provides for a greater social purpose such as the protection of consumers, workers, or the environment. When regulatory non-compliance occurs, these protections are compromised. The overriding purpose of sanctions is therefore to ensure that these protections are maintained and safeguarded.”⁹⁰¹ Therefore, at the heart of every mode of sanction should be the essential objective of achieving the safeguards which the regulation seeks to do in the first place. Consistent with this principle, the sanctions recommended above are principally aimed at ensuring that personality risks are managed and that the public is protected from the activities of high risk directors who have the potential to mismanage public companies. The notices and fines option should be triggered to elicit compliance. The disqualification, publicity and de-listing options serve to safeguard the regulatory aims by eliminating persistent defaulters. The listing requirement primarily serves to prevent default at the outset and secure compliance based on the overriding desire of a company to be listed.

It is also recommended that the regulatory model specifies that sanctions are not restricted to those contained in the provisions and that the external authority may from time to time incorporate sanctions which may be more appropriate in addressing the

⁹⁰⁰ Similar provisions exist under s 656 of the UK Companies Act 2006 which provides that directors are personally liable if they fail to abide the provisions of that section which relates to serious loss of capital.

⁹⁰¹ See the consultation document, (note 880) 19.

regulatory breach in question taking cognisance of changes in the regulatory atmosphere. The aim of this provision would be to enable regulatory assessment of the impact of available sanctions, and the adoption of necessary changes in keeping with responsive regulation.

7.3 THE MODEL AND THE PRESENT UK BEHAVIOURAL RISK MANAGEMENT MECHANISMS: LIMITATIONS IN THE STATUS QUO

The aim of this section is to highlight the areas in which the provisions of the model differs from the provisions in existing mechanisms which seek to manage personality and behavioural risks, particularly the FSA Approved Persons Regime and the UK Companies Act 2006.

7.3.1 THE FINANCIAL SERVICES AUTHORITY (FSA) REGIME

The FSA conducts an approval regime for companies operating in the financial services sector which it regulates.⁹⁰² The process for approval involves applicant firms submitting an application to the FSA in respect of individuals.⁹⁰³ Each firm is expected to have carried out its own internal due diligence, interviews and recruitment processes to assure it that the candidate being presented to the FSA for approval is a fit and proper person to perform a significant function. The candidate confirms the authenticity of the information on the application form by countersigning on the application form that he/she has provided the correct information throughout the process to the applicant firm.⁹⁰⁴ The applicant firm is required to verify the accuracy of the information provided before making the application to the FSA. It is the firm making the application to the FSA; hence the onus lies on the firm to provide sufficient information to satisfy the FSA that an individual is a fit and proper person.⁹⁰⁵ The firm has to provide details of its basis and rationale for reaching the conclusion that the candidate is fit and proper. The firm is required to disclose all matters relating to a candidate's fitness and propriety. If a candidate discloses adverse information to

⁹⁰² See the FSA Approval Process at their website <http://www.fsa.gov.uk/Pages/Doing/Regulated/Approved/persons/process/index.shtml> (accessed 15th June 2012).

⁹⁰³ For more on the regulatory activities of the FSA, see J. Dine & M. Koutsias, *Company Law* (6th ed., England: Palgrave Macmillan 2007) 106-116.

⁹⁰⁴ See the FSA website, (note 902).

⁹⁰⁵ Ibid.

the firm, or the firm learns of some adverse information through another means, it has a duty to disclose that information to the FSA.⁹⁰⁶ As part of the approval process, the FSA would normally interview candidates for the posts of Chair, CEO, Finance Director, Risk Director and some Non-Executive Director posts in high impact firms. The FSA may, at their discretion, interview candidates for other significant influence functions and for posts in low impact firms. In the case that the FSA proposes to refuse an application, a warning notice is given to both the firm and the candidate.⁹⁰⁷ They have the option of withdrawing the application or making oral or written representations to the Regulatory Decisions Committee of the FSA. Upon refusal of the application after this process, the firm and/or the candidate reserves the right to refer the refusal to the Financial Services Tribunal.⁹⁰⁸

A thorough analysis of the approval process as outlined above elicits an understanding of the limitations of the FSA regime in relation to the model suggested in this thesis. The points to be noted and in which the models differ are as follows:

- 1) The FSA regime is applicable only to companies in the financial sector. It is understandable that companies in the financial sector should be protected as their activities have the potential to impact highly on the functioning of the economy as a whole. However, this thesis argues for an extension of personality risk mitigating mechanisms to all public companies trading with funds from the public because of the potential impact of failures in companies such as those, and the fact that the society as a whole has a stake in the survival of such companies.
- 2) The applicant firms under the FSA regime are expected to undertake their own due diligence and processes in order to satisfy themselves that a candidate is fit and proper. However, companies are not given any specific guidelines as to how to achieve this aim. Firms are, therefore, at liberty to arrive at the conclusion that a candidate is fit and proper through any means they choose. It is right that the FSA would still vet that decision, but the issue in this case is that there are no specific standards across all the firms in the first instance. If a particular issue as regards the determination of fitness and propriety is sought to be standardised for all public listed companies, as is argued in this thesis, then all firms must undertake the vetting activity in relation to that specific issue in a manner that ensures similar standards are

⁹⁰⁶ Ibid.

⁹⁰⁷ Ibid.

⁹⁰⁸ Ibid.

operated consistently. For instance, there is no clear indication that all firms would undertake a personality assessment of candidates in the manner envisaged by this model. Some may do, but evidence indicates that the top echelons of corporate society are seldom subjected to personality tests or formal recruitment processes as are the regular employees of companies.⁹⁰⁹

- 3) The FSA itself does not undertake personality assessments. The fitness and propriety of candidates is apparently determined from past events as is evident from the answers to questions on the application form and other documents presented to the FSA, as well as the FSA's own verification exercise.⁹¹⁰ The FSA states that in the pursuit of its aim, the most important factors are the candidates' honesty, integrity and reputation; competence and capability; and financial soundness.⁹¹¹ A candidate's financial soundness would be discernible from past and present events which point to his/her financial dealings.⁹¹² Honesty, integrity and reputation can also be glimpsed from past and present events.⁹¹³ The FSA also states that it must be satisfied that a candidate would be open and honest and be able to comply with any requirements imposed on him.⁹¹⁴ This means that the candidate must be a dutiful person. If the literature and empirical evidence available indicate that only certain individuals are dutiful, then it becomes imperative in the determination of a candidate's ability to be dutiful, that there should be an assessment of that candidate's personality.⁹¹⁵

Competence and capabilities which relate to skills required to perform a role can be ascertained from a candidate's pedigree and past experiences. However, competence and capabilities which are dependent on a candidate's ability to perform a role as required and specified would involve more than the possession of the appropriate skills, even though those are essential and necessary. Just as indicated by the FSA, it is important to have candidates who would be open and honest and can be relied upon to comply with requirements in the exercise of their skills. Honesty and integrity are issues which emanate from personality, and the examination of past events alone

⁹⁰⁹ See Cadbury, (note 225); see also Dulewicz & Herbert, (note 224).

⁹¹⁰ See the website <http://www.fsa.gov.uk/Pages/Doing/Regulated/Approved/persons/fitness/index.shtml> (accessed 15th June 2012).

⁹¹¹ Ibid.

⁹¹² Ibid.

⁹¹³ Ibid.

⁹¹⁴ Ibid.

⁹¹⁵ See McCrae & Costa, (note 134); see also Hartmann, (note 542). See generally the discussions on personality in chapter five.

cannot suffice in the determination of whether a person would exhibit such traits in the future. A personality assessment is equally essential and would provide a broader knowledge from which to draw more reasonable conclusions as to the fitness and propriety of a candidate. In fact, a personality assessment provides indications as to a candidate's potential ability. For instance, a candidate may never have been involved in a known case of dishonesty in the past, but if that candidate is of a personality dimension which is likely to be dishonest, there is then the risk that he/she might be dishonest in the future. The whole purpose of the approval process is to ensure that candidates will perform as expected in the future. It is therefore a risk to take on a candidate who has a high potential to be dishonest due to his personality. It is a greater risk to the entire governance process if the personality of a candidate is not even known at all, because the first step in risk management and mitigation is the identification of the risk in question.

- 4) The FSA states that it interviews candidates for specific positions in high impact firms, and would interview other candidates and other firms at their own discretion.⁹¹⁶ It is understandable that the FSA might be taking cognisance of cost and time issues in not applying the interview process to all possible candidates, but, this situation generally leaves the process of determining the fitness and propriety of some candidates only to the facts presented by firms to the FSA in the application forms and any vetting that may be done by the FSA. This is a reason why there needs to be similar standards imposed across all firms. An interview process serves its own purpose in the approval process as face to face interactions can reveal some issues which may not be gained from papers alone, and in that way the interview process is a positive addition to the approval process. The FSA at its discretion decides when the interview process is not necessary. That is not an unreasonable approach in itself as an overall risk assessment of a particular situation might indicate that an interview is not needed. However, what it does do is create different standards. The FSA's regulatory approach is one that is risk based anyway, so one can understand that approach.⁹¹⁷ However, in the case that the same standards are sought to be enforced

⁹¹⁶ See the FSA website, (note 902).

⁹¹⁷ The FSA undertakes its regulatory and supervisory functions in a graduated manner dependent on the level of risk it perceives from firms. It is provided in the FSA Handbook that the purpose of taking a risk-based approach to supervision is to focus the FSA's resources on the mitigation of risks to the regulatory objectives, and to have regard to the need to use the FSA's resources in the most efficient and economical way, see the FSA handbook at <http://fsahandbook.info/FSA/html/handbook/SUP/1/3> (accessed 15th June 2012).

across all public companies as is the case envisaged in this model, then, if any value is to be gained by an interview process, it should be made applicable across board. A major advantage of creating similar standards in cases like this is that the issue begins to assume a normative force as it is viewed as applicable to everyone.

- 5) The FSA regime is concerned with approving candidates for a role. If the candidate is approved, then that is the end of the process, until the candidate engages in actions which are prohibited under the function. If a personality assessment is not conducted, every approved candidate has the potential to be unfit for the role approved. Therefore, the situation is one in which a candidate is assumed innocent until proven guilty. That may appear right in a criminal inquiry, but in the quest to prevent corporate mishaps, the better approach would be that prevention is better than cure.⁹¹⁸ Knowledge of the true potential abilities of candidates would place firms and the FSA in a better position to check excesses, as against waiting for the time when the candidate gets involved in wrong doing and then applying regulatory sanctions. Reviewing a candidate's past experiences and events is simply not conclusive evidence of his/her potential to be fit and proper for a future role. Personality is a phenomenon that impacts on actions and behaviour in different circumstances. It might take a specific circumstance in the future to highlight an individual's personality in relation to honesty and integrity for instance. Therefore it is essential that information regarding personality and its potentialities is known at the outset and taken into account in making assessments regarding the potential ability of an individual to be fit and proper.

If the test of fitness and propriety is to be founded only based on actual events, then there is a flaw in the entire process as it relates to risk management for the reason that risk itself is defined as the potential for an event to occur. Risk management therefore

⁹¹⁸ An illustrative story is in relation to P.K. Dick's fictional work, *The Minority Report*, in which "pre-crime" systems were used to identify persons who were about to commit crimes and then these persons were locked up in prisons in order to prevent the commission of the crime. The whole idea was to prevent the crime from occurring as the authorities reasoned that punishment was not much of a deterrent and could scarcely afford comfort to an already dead victim. Extreme as this seems, the underlying principle was effective risk management, but the main problem that is associated with such a system is that of ensuring with absolute certainty that a crime is about to be committed. Otherwise, a miscarriage of justice would be occasioned. The model suggested in this thesis does not seek to exclude persons from the governance process, but is rather aimed at identifying personality risks and putting processes in place to manage such risks. So, in relation to the above story, hypothetically, the model does not aim to lock up potential offenders, but watches over them in order to ensure to a reasonable extent that they do not offend.

involves an identification of the potential for an adverse event to occur and the decisions and actions developed towards responding to the occurrence of that event. This could involve a decision to eliminate the risk entirely, for instance such as is the case when the FSA disapproves of a candidate and denies that candidate a place in the governance of a firm. Risk management could also involve accepting the risk and putting measures in place to mitigate its occurrence or the impact of its occurrence. The suggested personality risk management model is aimed at identifying risks and managing risks, and not excluding any person from company management. In all scenarios of risk management, one basic necessity is the proper identification of the risk. A regime which is aimed at managing personality risks must identify these risks properly. This cannot be done effectively without a personality assessment. The suggested model proposes a personality assessment in addition to all other necessary assessments to determine honesty, integrity, reputation, competence, capability and financial soundness. Decisions are then made as to fitness and propriety based on the broader knowledge. For reasons such as the shareholders reserving the right to elect corporate officers, they may elect whosoever they desire. However, because the companies in question are publicly traded companies in which shareholders may differ from time to time and may not be involved closely in the affairs of the companies, the State has a duty to protect the public in relation to their funds.

In order to ensure a more effective management of those companies, if directors with less than appropriate personality dimensions are elected, those directors must be appropriately risk managed under an approved process as a means of mitigating their personality risks. If the company is a company in the financial sector, its officers would still undergo the process of approval established by the FSA in addition to the personality assessment process proposed in the model. Where the FSA approves the candidate for the role, but the personality assessment illustrates that the candidate's personality is not appropriate, the company may engage the candidate as proposed in the model and the risk management procedure kicks in. Overall, this process would increase the chances of preventing corporate failures. In addition to providing the essential information on the personality dimensions of company directors for the benefit of shareholders in order to aid the selection of appropriate directors, the model additionally provides a personality risk management procedure to manage the risks which accrue from the selection of inappropriate directors.

7.3.2 THE UK COMPANIES ACT 2006

The Companies Act 2006 is the main legislative instrument specifying requirements for the origination, management and demise of companies in the UK. There is no precise definition of directors under the Act save in section 250 which states that a director “includes any person occupying the position of director, by whatever name called”. The Act does not also distinguish between executive and non-executive directors.⁹¹⁹ Also, there are no provisions in the Act relating to personality assessment of company directors at the point of recruitment. Regarding the qualification for directorship in companies, the Act only specifies a minimum age of 16 in section 157. However, there are other negative considerations such as the Company Directors’ Disqualification Act 1986 which specifies that undischarged bankrupts are ineligible to serve as directors except with the leave of the court.⁹²⁰ Therefore, as far as assessments at recruitment are concerned, the Act has no specific provisions. With regard to mechanisms aimed at mitigating issues which may arise as a result of personality risks, the Act establishes a statutory code of duties which a director owes to the company. These directors’ duties are aimed at setting standards in relation to the behaviour to be expected from company directors in the discharge of their functions. The duties are set out in sections 170-177 of the Companies Act 2006.

Considering the actions which have contributed to corporate failures, the most relevant duty which may impact on the behaviour of directors would appear to be section 172. Section 172 provides that “a director of a company must act in the way that he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in so doing the director must have regard to a whole range of matters which include the likely consequences of any decisions in the long term; the interests of the company’s employees; the need to foster the company’s business relationship with suppliers, customers and others; the impact of the company’s operations on the community and the environment; the desirability of the company maintaining a reputation for high standards of business conduct; and the need to act fairly as between members of the company.” Section 172

⁹¹⁹ See Belcher & Naruisch, (note 847).

⁹²⁰ See s 11 of the Company Directors Disqualification Act 1986.

clearly elucidates the expectations of the law from company directors in terms of standards of behaviour in the governance of companies. However, the pertinent question remains whether all company directors are capable of complying with the provisions of section 172. The fact that a director is mandated by company law to act in a certain manner is not conclusive evidence that the director can and will act in that manner. If a director decides not to so act, the consequences of breaching the duty should follow. But, the fact would remain that the enactment of the duty does not in itself automatically contribute towards ensuring that directors are persons who are likely to abide by the duty. As with all laws with consequences in the form of punishment, there is an underlying assumption that the possibility of punishment in cases of contravention would act as deterrence, but there are two major arguments that count against the utility of consequences as deterrence in this case. Firstly, consequences originate after the harm has been done, so in a case where the more important issue is prevention rather than cure, and the gains of contravention outweighs the pains of the consequences, there is a risk that the consequences would not serve their purpose as a preventive mechanism.⁹²¹ Secondly, in the event that the issue in question hinges on capabilities, and there is evidence which supports the notion that only certain personality dimensions can be relied upon to be dutiful, it does not appear reasonable to expect persons who are not of those personality dimensions to always abide by the duties specified in the Companies Act.⁹²²

It therefore becomes a risk to the entire corporate governance system to recruit directors whose personalities are unknown and who may have personalities unsuited to the delivery of effective corporate governance. The duties specified under the Act may, therefore, become prone to being disobeyed simply because of the personalities of directors. If there is a mechanism in place which ensures that company directors are dutiful persons, then there is an increased probability of the duties being obeyed, and the aims of the duties being achieved. If the personality assessment proposed in this model is adopted into company law, and the provision specifies an assessment at the point of recruiting directors, with a report on that activity to be filed as part of incorporation documents in the case of new companies, or periodic returns in the case of existing companies, then company law would go further in terms of the mitigation

⁹²¹ See Crowther, (note 304); see the discussions in chapter three, section 3.4, p 69-70.

⁹²² See generally the discussions on personality in chapter five.

of personality risks in corporate governance. Also, if company law incorporated provisions mandating the application of personality risk management in cases where inappropriate personality dimensions have been selected by company shareholders, there will be a higher level of personality risk mitigation than exists in the present provisions.

7.4 PRACTICAL IMPORTATION OF THE MODEL IN THE PRESENT UK REGIME

Public listed companies in the UK must abide by the provisions of the UK Companies Act 2006 and the UK Corporate Governance Code 2010 and so an evaluation of how this model might fit into these two regulatory mechanisms is required, particularly in the event that these mechanisms are to be utilised in actualising the purposes of the model. First, the mandatory provisions relating to the identification of the personality of directors and the adoption of a personality risk management procedure can be incorporated into company law. For instance, the information on the most appropriate personalities for corporate governance could be provided under Part 10, Chapter 1 which deals with the appointment and removal of directors. Chapter 2 of that Part deals with the general duties of directors and the mandatory provisions requiring directors to be evaluated can be added into that chapter as that function is most likely to be undertaken by existing directors. The provision could also specify that shareholders or company promoters are mandated to undertake the procedure in respect of first directors. Again, in relation to company registration, section 9 which deals with registration documents could also be amended to include the requirement for a statutory declaration by the directors that the evaluation procedure has been undertaken.

Second, the soft law and self-regulatory provisions in the model could easily be incorporated into the UK Corporate Governance Code. The information on the appropriate personality types for corporate governance could also be incorporated into the code as part of its recommendations under Provisions B.1 which deals with the composition of the board. The functions of the nominations committee under Provisions B.2 and particularly under Provision B.2.2 which requires the committee to evaluate the balance of skills, experience, independence and knowledge on the board

can be extended to include the evaluation of the personality of directors. Also, the personality risk management requirement of this model can be incorporated into Provisions C.2 and Provisions C.3 which deals with risk management, internal control, auditors and audit committees. The UK Corporate Governance Code operates on a “comply or explain” basis which essentially connotes that its provisions may not be complied with and the company may just explain its reasons for non-compliance. To the extent that the nominations committee would have the choice of selecting whichever directors they want irrespective of the recommendations for a company to select the most appropriate type of directors, the “comply or explain” approach fits perfectly.

However, in relation to the personality risk management procedure which must be undertaken, the company must comply with the regulatory requirement and the provisions in the corporate governance code can only relate to the particular method of risk management undertaken by the company as it would have the choice of adopting the recommendations provided in the model or using its own procedure. The recommended risk management procedure can be incorporated into the code or reference can be made in the code to a document which contains the recommended provisions. The code can then contain provisions which require the company to either comply with the recommendations or use one of its own, details of which would be reported to the regulatory agency. There could also be recommendations for the company to include reports on its personality risk management procedure in its annual reports as it would include other relevant reports.

In relation to sanctions, provisions for notices and fines can be included in the amended provisions of the Companies Act 2006 and the Directors’ Disqualification Act 1986 can also be amended to include provisions stating that a director may be disqualified for persistent non-compliance with the provisions of this regulatory model. The options for publicity and de-listing can also be provided for in the Companies Act as well as a proviso stating that the sanctions are not exhaustive. As regards administration, the provisions could be administered the same way as the other provisions in the Companies Act and Corporate Governance Code. Advantages of incorporating these regulatory provisions into existing structures include a reduction in the cost and time of developing new legislation, acceptability of

provisions as emanating in the form of amendments to existing and familiar regulatory structures, and reduction in administrative burdens.

However, considering the reporting requirements of this model and the suggestion for the establishment of an external authority to administer its provisions, incorporating the provisions of the model under these existing regulatory mechanisms would require additional provisions to be made for the establishment of such an external authority or assignment of the administration of the provisions by an existing regulatory authority. This is certainly possible under the Companies Act because the Act confers powers on the Secretary of State in sections such as 156 & 158, and so it would not be too farfetched for the Act to confer powers on an external regulatory authority in relation to specific provisions contained therein. The FSA regime aims to manage behavioural risks. If the regime adopted an identification process for personality risks and incorporated a risk management process akin to that envisaged by the model in this thesis, then the process of managing personality risks in its entirety could be undertaken by the FSA. The only pitfall would be that it would only be applicable to companies in the financial services sector, and the argument in this thesis is that personality risks should be identified and managed in relation to directors of all public listed companies.

The alternative approach to incorporating the regulatory provisions in existing regulatory structures would be to enact a specific piece of legislation for the purpose. For example, an Act might be promulgated to contain the mandatory provisions and sanctions whilst the voluntary recommendations might be provided in an advisory document or guidance for companies. The Act enacted for this purpose could be titled “The Corporate Governance Act”, and its aim could be stated as providing for the evaluation of company directors of public companies and the risk management of high risk company directors. The Act would specify the external authority which would administer its provisions, the powers of such an authority and all other incidentals. Likewise, the guidance containing the recommendations could be titled “The Corporate Governance Guidance for the Appointment of Company Directors”. The guidance would contain all the recommended provisions and could also become a reference document specified in the corporate governance code.

In relation to evaluating the effectiveness of the model in the long term and developing improvement processes for the risk management mechanisms incorporated into the model, a provision could be included in the Insolvency Act 1986 to the effect that in cases of corporate failures, a detailed report should be prepared as regards the personality of the company directors and the risk management process that was adopted in relation to their personality status. The same process can also be undertaken when companies are restructured as a result of failure. In the long term, this can help to ascertain the effectiveness of the model in relation to reducing corporate failures and the impact of the model on corporate risk management processes.

7.5 CONSIDERATIONS IN RELATION TO THE MODEL

The following are some further considerations in relation to the model:

7.5.1 MOST APPROPRIATE PERSONALITY DIMENSION FOR CORPORATE GOVERNANCE

Considering the literature and discussions in chapter five, it is evident that certain personality dimensions are better suited to corporate governance than others.⁹²³ As regards leadership, literature reiterates that the personality dimensions of extraversion, conscientiousness and openness to experience are the best suited and most indicative of positive leadership ability.⁹²⁴ In relation to actual job performance, the personality dimension of conscientiousness has been found to have the highest validity amongst the big five dimensions of personality for overall job performance.⁹²⁵ Extraversion, agreeableness and openness to experience were also shown to have some validity depending on the job criterion.⁹²⁶ As argued in chapter five, a combination of all these appropriate traits would be most conducive to corporate governance. However, working on the assumption that these perfect combinations may not always be in existence, it becomes important for the sake of personality risk management to

⁹²³ See generally the discussions in chapter five, section 5.5.

⁹²⁴ See Judge et al, (note 618); see also Kirkpatrick & Locke, (note 146); see also O'Connor & Jackson, (note 628).

⁹²⁵ See Hurtz & Donovan, (note 645); see also Mount & Barrick, (note 647); see also Salgado, (note 647); see also Behling, (note 647).

⁹²⁶ See Hurtz & Donovan, *ibid*.

decipher which dimensions are so vital to overall corporate governance that it is most appropriate to have such personalities on corporate boards.

A starting point in this exercise would be to reflect on the personality dimension of conscientiousness, which is consistent with leadership ability and is also the most consistent with overall job performance.⁹²⁷ As noted above, other personality traits are valid across job performances depending on the job criterion, but conscientiousness is valid across all job performances.⁹²⁸ The particular job criterion required for corporate governance may differ from company to company, but, according to the evidence from literature, a conscientious personality is likely to perform optimally in any role in any company.⁹²⁹ One reason why this is the case is because a conscientious personality has the trait of dutifulness.⁹³⁰ In any job function, there are usually rules and regulations which guide the performance of that function. These guidelines are usually formulated to help ensure the achievement of optimal performances on that job.⁹³¹ In situations where persons are dutiful enough to abide by these established rules and regulations, chances are much higher that the job would be performed more effectively than would be the case if these persons were not dutiful.⁹³² All the traits of conscientiousness as is highlighted in chapter five are traits which are naturally conducive to effectiveness.⁹³³

Company directors are usually in leadership positions in a company, but nevertheless, they are engaged in both leadership and performance roles in the steering of the company, and so their personality becomes important in the actualisation of all corporate goals. There is no reason why company directors should not be subjected to personality tests in the same way as the employees of some companies are subjected to in order to make judgments as to their ability to accomplish the tasks they are to undertake if recruited. It is important to determine the personality dimensions of directors and take steps to ensure that if less than appropriate personalities are

⁹²⁷ See Judge et al, (note 618); see also Hertz & Donovan, *ibid*.

⁹²⁸ See Hertz & Donovan, *ibid*.

⁹²⁹ See Moberg, (note 674); see also Judge et al, (note 618); see also Hertz & Donovan, *ibid*.

⁹³⁰ See McCrae & Costa, (note 560); see also Paunonen & Ashton, (note 569); see also Christopher et al, (note 380).

⁹³¹ See for instance the Revised Turnbull Guidance, para 19 which indicates that internal control rules are established to facilitate the effective operations of a company.

⁹³² See Christopher et al, (note 380).

⁹³³ These traits include self-discipline, competence, dutifulness, achievement striving, personal organisation and deliberation. See McCrae & Costa, (note 560); see also Moberg, (note 674).

selected as directors, then a personality risk management programme is triggered in order to mitigate personality risks. Evidence from the accounts given of the behaviour of corporate officers in some of the major corporate failures that have occurred such as Maxwell, HIH, Enron, WorldCom, Lehman Brothers all show a recurrent thread of company directors failing to abide by established rules and regulations in corporate governance.⁹³⁴ One of the major arguments in this thesis is that the inappropriate personality of company directors has contributed significantly to corporate failures in the past. For instance in the HIH failure, the report of the Royal Commission which investigated the failure stated that whereas the law imposed duties on directors to disclose situations which may adversely affect a company, the officers at HIH failed to do this and in fact concealed the true state of affairs of the company, a situation which contributed directly to the failure of the company.⁹³⁵ Similar situations occurred in other corporate failures.⁹³⁶

As has been highlighted in chapter two, corporate governance reforms in response to corporate failures have often focused on creating and enhancing rules, regulations and principles pertaining to governance structures, but, these efforts overlook the pertinent issue of the persons who are to abide by these reforms and whether they can and will do so.⁹³⁷ In the Lehman Brothers failure, there were established rules, regulations and principles, supposedly reformed after previous corporate failures, but that company still failed because some of its directors and officers circumvented established rules, regulations and principles.⁹³⁸ It is evident that more needs to be done in the form of reforms if enhanced effectiveness in corporate governance is to be achieved, and this thesis offers one essential reform in that direction, a focus on the personality of company directors, as well as the risk management of company directors who do not have the potential to always abide by established rules, regulations and principles. In this model therefore, it is suggested that the recommendation as to the most appropriate personality dimension for corporate governance should indicate that the conscientious personality is the most essential

⁹³⁴ See Wearing, (note 2); see also Clarke, (note 124); see also Bower, (note 126); see also McLean & Elkind, (note 129); see also Deakin & Konzelmann, (note 129); see also the HIH Royal Commission Report 2003, (note 128); see also Jeter, (note 130); see also The Lehman Examiners' Report 2010, (note 131).

⁹³⁵ See the HIH Report, *ibid*.

⁹³⁶ See note 934.

⁹³⁷ See the discussions in chapter two, section 2.6.

⁹³⁸ The Sarbanes-Oxley Act was promulgated in response to the Enron failure in 2002, but the officers at Lehman Brothers flouted s 401 of that Act in relation to the disclosure of off-balance sheet items.

personality dimension required for the delivery of effective corporate governance. Based on the fact that other personality dimensions are suited to specific job criteria, for example, extraversion and agreeableness are well suited to jobs which pertain to inter-personal relations;⁹³⁹ there should also be an indication of the other positive personality dimensions and the job criteria which they are best suited to. However, in relation to the decision as to who qualifies as a low risk director, it is suggested that a director who has a high score in the conscientiousness dimension and possesses the dutifulness trait should be classed as low risk. The reasoning behind this is that such a director is the one most likely to perform effectively as a leader and on the job, and particularly because such a director is likely to abide by established rules, regulations and principles of corporate governance.

As was noted in chapter five, the risks of a conscientious director acting contrary to the provisions entrenched in corporate law and corporate governance codes are low.⁹⁴⁰ Likewise, a director who is not conscientious should be adjudged high risk because there is a higher possibility that such a director would fail to abide by established rules, regulations and principles, thereby contributing higher levels of risk to the entire corporate governance process. It is then suggested that such high risk directors should be managed under a personality risk management process which should, amongst other issues, monitor them to ensure that they are abiding by established rules, regulations and principles. This way, corporate objective would stand a higher chance of being achieved and not truncated. This model is not focused on the total elimination of all possible personality risks because in the nature of risks, that might not be feasible.⁹⁴¹ The overall aim, however, is the mitigation of personality risks based on the already established knowledge that certain personality dimensions are better suited to corporate governance. It means that in cases where the personalities that are better suited to governance are recruited, then the risk of uncertainty, threats and adverse consequences as to the outcome of their performance would be at a lower level. Conversely, where inappropriate personalities are recruited, the situation is managed under a personal risk management procedure which still places the company

⁹³⁹ See Hurtz & Donovan, (note 645).

⁹⁴⁰ See Moberg, (note 674).

⁹⁴¹ The aim of risk management is essentially to reduce risks to a level acceptable by society, by using strategies such as transferring it, avoiding it, reducing its negative effect or accepting some or all of its consequences. See Agrawal, (note 165).

in a better position in relation to circumstances in which such risks are unidentified and unmanaged.

In relation to evaluation tests, taking account of recent literature which suggests that third party observations/observer ratings yield incremental validity over self-reports/personal inventories,⁹⁴² it is suggested that the personality evaluation to be undertaken should combine the results obtained from regular personality inventories with that obtained from interviews and observer ratings in order to arrive at a more accurate and objective picture of the personality in question. The idea behind this is to maximise the advantages and minimise the disadvantages inherent in various approaches, for instance, the NEO PI-R self-reports could be inaccurate because of reasons such as the respondent being careful of answers.⁹⁴³ However, as discussed in chapter five, the NEO PI-R remains the most valid and best measuring model in existence.⁹⁴⁴ Again, observer ratings capture mostly the reputation of an individual and reputation is adjudged a good predictor of performance.⁹⁴⁵ Well acquainted observers can provide equally accurate information about an individual.⁹⁴⁶ However, one limitation of observer ratings is that an observer may not have the opportunity to observe another individual's behaviour across all times and across all situations; and some traits are highly personal to individuals and may not even be observable.⁹⁴⁷ Therefore, it would be useful to combine various approaches and increase the chances of getting accurate results as to the personality dimensions of company directors.

7.5.2 DATA PROTECTION AND PRIVACY ISSUES

Taking account of the provisions of the suggested model which mandate the necessary disclosure of information regarding the personality of company directors, it is essential to consider the provisions of the UK Data Protection Act 1998 (the Act) and the EU Draft Regulation on data protection. The Data Protection Act in part I, section 1 defines personal data as “data which relate to a living individual who can be identified from those data or from those data and other information which is in the possession of, or is likely to come into the possession of, a data controller, and

⁹⁴² See Oh et al, (note 612).

⁹⁴³ See Hartmann, (note 542) 159.

⁹⁴⁴ See Hartman, *ibid*; see also McCrae & Costa Jr., (note 560) 510.

⁹⁴⁵ See Oh et al, (note 612) 764.

⁹⁴⁶ See Kolar et al, (note 656).

⁹⁴⁷ See Oh et al, (note 612) 764.

includes any expression of opinion about the individual and any indication of the intentions of the data controller or any other person in respect of the individual". In terms of this definition, information regarding the personality of an individual is personal data, and in the hands of a data controller, processing such information is subject to the provisions of the Act. A data controller is explained in the Act as a person/s who determines the purposes for which and the manner in which personal data is processed. A data subject is an individual who is the subject of personal data. In part I, section 2, sensitive personal data is stated as referring to information relating to issues such as racial/ethnic origin, religious beliefs, political opinions, physical or mental health or conditions, sexual life and the commission or alleged commission of an offence and related proceedings and sentences. Therefore, the Act does not expressly categorise information as to individual personality as sensitive personal data. However, one might argue that the personality of an individual could in some sense be categorised as part and parcel of his mental health. If that argument is favoured, then personality information is viewed as sensitive enough to be covered by the provisions of the Act in relation to sensitive personal data.

Of particular interest in relation to personality information would be the provisions of part II, sections 7, 10 and 12. Section 7 deals with a data subject's right of access to his/her personal data. Section 10 provides that the data subject has a right to prevent processing of such information which is likely to cause damage or distress. Here, the individual can prevent the processing of such information on the grounds that it would cause substantial damage/distress to him or to another, and that such damage/distress is or would be unwarranted. However, the Act subsequently provides that the above provision shall not apply if any of the conditions set out in para 1-4 of schedule 2 is met or in such other cases as may be prescribed by the Secretary of State. Section 12 provides that an individual has the right to require that no significant decision concerning him/her is taken based solely on the automated processing of personal data for the purpose of evaluating matters such as his/her performance, reliability or conduct. Sub-sections 6 and 7 provide exemptions to the provision in section 12. Sub-section 6 implies that section 12 does not apply if the decision is taken as part of steps for the purpose of considering whether or not to enter into a contract with the individual or with a view to entering such a contract or in the course of performing such a contract; or is authorised or required by or under any enactment. Sub-section 7

provides that section 12 would not apply if the effect of the decision was to grant a request of the data subject or steps have been taken to safeguard the legitimate interests of the data subject such as allowing him/her to make representations.

The data protection principles are outlined in schedule 1 of the Act. These principles provide that personal data must be processed fairly and lawfully and must not be processed except at least one of the conditions in schedule 2 is met and one in schedule 3 for sensitive personal data. The principles also state that personal data shall be adequate, relevant and not excessive in relation to the purpose or purposes for which they are processed. The principles also require that appropriate technical and organisational measures shall be taken against unauthorised or unlawful processing of personal data and against accidental loss or destruction of, or damage to, personal data. Schedule 2 outlines the conditions relevant for the purposes of processing personal data. Such conditions include that the data subject has given his consent to the processing, the processing is necessary for the performance of a contract to which the data subject is a party, the processing is necessary for compliance with any legal obligation to which the data holder is subject, the processing is necessary for the administration of justice, or the processing is necessary for the exercise of any functions of a public nature exercised in the public interest by any person.

In relation to sensitive personal data, schedule 3 outlines the conditions and these include the data subject giving his explicit consent, the processing is necessary for the purpose of exercising or performing any right or obligation which is conferred or imposed by law upon the data holder in connection with employment. Part IV of the Act provides some exemptions to the compliance with certain provisions of the Act. One of these exemptions is in section 31 in relation to regulatory activity. That section provides that the provisions of the Act as regards subject information are exempted in any case to which the application of those provisions would be likely to prejudice the proper discharge of relevant functions designed for the protection of members of the public against issues such as financial loss due to dishonesty, malpractice or other seriously improper conduct, or the unfitness or incompetence of, persons concerned in the provision of banking, insurance, investments or other financial services or in the management of corporate bodies.

Section 27 explains that the subject information provisions refer to the first data protection principle to the extent that it requires compliance with para 2, part II of schedule 1 and section 7 of the Act. Para 2, part II of schedule 1 provides that under the first principle in relation to data being processed fairly, the data subject should be provided with information regarding the identity of the data controller and any nominated representatives, the purpose/s for which the data is processed, and any further information which is necessary. Section 7 deals with the rights of data subjects and includes provisions such as the individual being entitled to obtain information from the data controller regarding the personal data held for him/her, the purposes for which they are being or are to be processed and the recipients or classes of recipients to whom they are or may be disclosed. The individual is also entitled to have communicated to him information constituting his personal data and the source of such information. The individual is also entitled under section 7 to be informed of the logic involved in any decision making based solely on the result of processing his/her personal data by automatic means for the purpose of evaluating matters such as his performance, reliability or conduct.

Considering the above provisions of the Act, the conclusion to be drawn is that as long as personal data, even sensitive data, are processed in accordance with the principles of data protection, and in compliance with the provisions of the Act, then the data controller is not in breach of the law. The principles generally mandate that personal data be processed in a manner that safeguards the rights of data subjects and in a situation where at least one of the conditions of schedule 2 or 3 is met. One of the conditions common to both schedules is the consent of the data subject. This means that if the consent of the individual is obtained, then the data controller is within the law. In situations where the individual (the company director), as in the suggested model, is aware and consents to a personality evaluation being conducted and the information used for the purposes of determining his prospective employment in a company, then the conditions stipulated in the Act are met. The Act specifically provides in section 12 (6) that decisions can be made utilizing personal data for the purpose of considering whether to enter into a contract with a data subject.

In the case of recruiting company directors, the company as represented by its shareholders enter into contracts with the directors to manage the company, and so in this situation, the Act sanctions the utilisation of personal data in the decision making

processes in relation to these contracts. In relation to disclosing personal data, the Act also makes certain exemptions in relation to regulatory functions as discussed above. The import of those provisions is that personal data which is held and disclosed in the course of discharging functions such as those stated in the Act would not be subject to the rights of the data subject as provided for under the subject information provisions of the Act. So, for instance, in the case of the suggested model, if a government authority is the data controller, and has other representatives, this information does not have to be disclosed to the data subject. Also, the data controller is not entitled to disclose the recipients or classes of recipients to whom the personal data can be disclosed. In these cases, the processing of the personal data is not to be viewed as unfair in contravention of the first principle of data protection. However, the provisions of the suggested model indicate that the directors will be aware of the recipients of the personality information, which are the shareholders, the board of directors, the stock exchange and the external authority.

In relation to personality information, it might be argued that personal data is subject to these exemptions in relation to regulatory functions but the same cannot be said of sensitive personal data.⁹⁴⁸ However, as highlighted earlier, the Act does not expressly categorise personality information as sensitive personal data, a fact which places such information under the purview of personal data and subject to the exemptions. In any case, even in relation to sensitive personal information, the Act provides in schedule 3 that one of the conditions relevant for the fair and lawful processing of such data is that processing is necessary for the performance of any obligation conferred or imposed by law on the data controller in connection with employment. Therefore, if there is a law that mandates the processing of such personal information for the purposes of employment as a company director, such as the suggested regulatory model, then the provisions of the Data Protection Act are not contravened in cases where the personality information relating to company directors is utilised for the purposes of their employment. Schedule 3 also provides in para 3 that processing of sensitive personal data is fair and lawful if done in order to protect the vital interests of another person, in cases where the consent of the data subject has been unreasonably withheld. Therefore, in this case, where one of the aims of processing

⁹⁴⁸ The Act does not ascribe the exemptions to sensitive personal data because the wording of s 31 specifically refers to "personal data".

the personality information of company directors is to protect the interests of society, it becomes fair and lawful to do so even when the directors have refused to give their consent unreasonably. However, it is expected that directors would consent to the obtaining and utilisation of such data as it is done in the course of their employment prospects. In any case, they can of course refuse to consent and thereby refuse to be considered for the directorship role.

In terms of the suggested model, the personality information does not automatically preclude the employment of a director as that is ultimately for the shareholders to decide, but the information serves its own purpose for the regulatory framework. Therefore, as is indicated in the provisions of the Data Protection Act referring to the rights of data subjects in relation to decisions made as a result of processing personal data by automatic means, the personality information is not used as the sole determinant of an employment decision in this case, because the shareholders have the right and opportunity to take cognisance of other factors. Schedule 3, para 7A (b) of the Act also provides that processing sensitive personal data is fair and lawful if done for the purpose of preventing fraud or a particular kind of fraud. Therefore, processing personality information for the purposes of preventing persons who are capable of fraudulent activities from becoming company directors or managing the risks associated with them in order to help prevent fraud is fair and lawful. As long as the processing of personality information is done in accordance with the principles of data protection and in compliance with the provisions of the Data Protection Act 1998, there should be no negative issues raised as to the import of the provisions of the suggested model in relation to data protection.

In January 2012, the EU published a Draft Regulation on data protection.⁹⁴⁹ This Regulation repeals Directive 95/46/EC which dealt with data protection and the guarantee of the free flow of personal data between Member States.⁹⁵⁰ Article 5 of the draft Regulation requires that personal data must be processed lawfully, and must

⁹⁴⁹ See the Proposal for a Regulation of the European Parliament and of the Council on the protection of individuals with regard to the processing of personal data and of the free movement of such data [25:01:2012] http://ec.europa.eu/justice/data-protection/document/review2012/com_2012_11_en.pdf (accessed 15th June 2012). The right to protection of personal data is established by Article 8 of the European Convention on Human Rights (ECHR) which deals with the right to respect for privacy and family life.

⁹⁵⁰ See Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data, OJ L 281/31.

be adequate, relevant and limited to the minimum necessary in relation to the purposes for which they are processed. Article 6 provides that processing of personal data shall be lawful only if at least one of the conditions listed in sub-sections (a) to (f) apply. These conditions include that the data subject has given consent, that the processing is necessary for the performance of a contract, and that the processing is necessary for the performance of a task carried out in the public interest. Article 7 outlines the conditions requisite for a valid consent. Under Article 14 and 15, the data subject is entitled to information relating to issues such as the recipients or categories of recipients of the personal data and the period for which the personal data will be held. Of particular relevance in relation to the evaluation of the personality dimensions of directors and information relating thereto are the provisions of Article 20 of the draft Regulation which deals with measures based on profiling and states as follows:

*Every natural person shall have the right not to be subject to a measure which produces legal effects concerning this natural person or significantly affects this natural person, and which is based solely on automated processing intended to evaluate certain personal aspects relating to this natural person or to analyse or predict in particular the natural person's performance at work, economic situation, location, health, personal preferences, reliability or behaviour.*⁹⁵¹

However, there are exceptions to this general provision under sub-section 2. A person may be subjected to the measures prohibited under Article 20(1) if the processing is undertaken in the course of entering into, or the performance of, a contract and where suitable means have been adduced to safeguard the data subject's legitimate interest such as the right to obtain human intervention; if the processing is expressly authorised by a Union or Member State law which also provides suitable measures to safeguard the data subject's legitimate interests; or the processing is based on the data subject's consent subject to the conditions laid down in Article 7 and to suitable safeguards. These provisions are similar to those in the Data Protection Act 1998. Taking account of these provisions in relation to the model

⁹⁵¹ See the Draft Regulation, (note 949), Art 20 (1).

suggested in the thesis, there will be no infringement of data protection laws if the directors consent to the processing of their personal data. Again, particularly in relation to the provisions of Article 20, personal data can be processed in relation to a contract of employment or where State regulation mandates such processing of personal data. The regulatory model in this thesis requires the processing of personal data in regard to the contract between directors and shareholders of companies and provides the opportunity for human intervention to the extent that the shareholders are still allowed to select directors irrespective of their personality dimensions. In this way, the legitimate rights of the directors are protected because the model does not suggest an automatic exclusion of inappropriate directors. Also, there are human interventions at every stage of the processes suggested by the model considering the external regulatory oversight. The underlying aim of the suggested model is personality risk management and it does not foreclose the opportunity of employment as a company director. In conclusion, if the principles and laws of data protection are adhered to, as is the case in the suggested model, personal data in relation to company directors can be processed and utilised without any liabilities. One essential element in relation to data protection is obtaining the consent of the data subject, so in the event that a prospective director declines his consent as regards the personality risk management process, then the process does not have to be undertaken, and he or she will not become a director of a public listed company.

The practical implications of the data protection laws as discussed above can be illustrated with an examination of the FSA Approved Persons' Regime and the Protection of Vulnerable Groups (PVG) Scheme managed by Disclosure Scotland,⁹⁵² an executive agency of the Scottish Government. Under the FSA's regime, the candidate countersigns the application form as a confirmation of the authenticity of the information provided.⁹⁵³ This is interpreted as the candidate providing consent for the company to disclose the information contained in the application form to the FSA for the purposes of determining the fitness and propriety of that candidate for the role in question. This provision is in accord with the requirements of the Data Protection Act 1998. The Protection of Vulnerable Groups (Scotland) Act 2007 which is the

⁹⁵² This agency was established in 2002 to deliver the Scottish Ministers' functions under Part V of the Police Act 1997.

⁹⁵³ See the FSA Approval Process, (note 902).

legislation under which the PVG Scheme operates provides in section 68 (1) that the disclosure of disclosure information is lawful when undertaken by the individual to whom the information relates and by any other person with the consent of the individual to whom the information relates.⁹⁵⁴ Therefore, in relation to data protection and privacy issues, the consent of the data subject validates the processing and disclosure of personal data to specified recipients.

It is recognised that even where personal data such as information on the personality of directors is processed in accordance with data protection and privacy rules, there might be cases in which individuals are reluctant to share their personal information with certain recipients and in certain circumstances in order to protect their privacy and reputation. The regulatory model suggested in this thesis envisages the disclosure of information regarding the personality of company directors of public listed companies to its shareholders, boards of directors and regulators. The prospective directors would be made aware of this group of recipients as persons who need to utilise the information on their personality as part of the proposed personality risk management process. Even though in a public listed company any member of the public is a potential shareholder, the information regarding the personality of directors is disclosed only to actual shareholders, and this is considered necessary as part of ensuring the effective management of companies and prevention of corporate failures attributable to inappropriate behaviour. The choice is between the prevention of disclosures relating to personality in order to safeguard the privacy of individuals and the disclosure of such information to necessary recipients in order to identify and manage personality risks and thereby enhance effective corporate governance in public listed companies. It is granted that this scenario might result in some reluctance by persons applying or being approached to take up directorial roles. However, a balance has to be created between being conscious of the sensitivity surrounding such disclosures and the achievement of the positive aims of the

⁹⁵⁴ See the Disclosure Scotland website

http://www.disclosurescotland.co.uk/guidance/infofororg/chap5_sharingdisc/5_1_perm.html (accessed 15th June 2012). A disclosure is a document containing impartial and confidential criminal history information held by the police and government departments which can be used by employers to make safer recruitment decisions, see <http://www.disclosurescotland.co.uk/what-is-disclosure/> (accessed 15th June 2012).

model.⁹⁵⁵ The pool of potential directors might decrease, but, it is better to have fewer directors who are appropriate persons and are more capable of effective corporate governance than a larger pool with persons who have the potential to behave inappropriately, with no mechanisms in place to identify and manage the risks associated with their inappropriate personality and thereby exposing public listed companies to the possibility of corporate failure due to behavioural issues.

7.5.3 REGULATORY IMPACT ASSESSMENT

A key practical consideration in relation to the suggested model would be the undertaking of a regulatory impact assessment. The UK Better Regulation Executive indicate that impact assessments enable an identification of the regulatory measures which will achieve the government's policy objectives, while minimising costs and administrative burdens.⁹⁵⁶ It is also stated that impact assessments provide those interested in the process an opportunity to identify any potential consequences, minimising the risk of future problems.⁹⁵⁷ The EU better regulation initiative states that "impact assessment is designed to help in structuring and developing policies. It identifies and assesses the problem at stake and the objectives pursued. It helps to identify the main options for achieving the objectives and analyses their likely impacts in the economic, environmental and social fields. It outlines advantages and disadvantages of each option and examines possible synergies and trade-offs."⁹⁵⁸ In

⁹⁵⁵ The issue of balancing the necessary interests is also reflected in the FSA's approach to disclosure. In deciding whether to publish details of its prohibition orders in the FSA register, the FSA balances any possible prejudice to the individual concerned against the interest of consumer protection. See s 6.19 of the FSA Enforcement Guide <http://fsahandbook.info/FSA/html/handbook/EG/link/PDF> (accessed 15th June 2012). Therefore, in relation to the suggested model, one prejudice which might arise out of disclosure is a taint on the reputation of the individual, but, this is ameliorated by the fact that the process does not aim to exclude persons automatically from company management, and a high risk director will still have the opportunity to prove that he/she is able to contribute towards effective corporate governance. This is because as long as that director abides by corporate governance principles, established rules and regulations, and corporate failure does not occur as a result of his/her inappropriate behaviour, then the issue of his/her high risk personality will not appear detrimental in the long term. Considering this, it is better to make the necessary disclosures and ensure that corporate failures are prevented, because even if the personality risk management process is not instituted and corporate failure occurs, the reputation of the company directors will still be compromised and more permanently in this case as the public might lose confidence in them as directors and they may in fact be disqualified.

⁹⁵⁶ See the BIS website <http://www.bis.gov.uk/policies/bre/assessing-impact> (accessed 15th June 2012).

⁹⁵⁷ Ibid.

⁹⁵⁸ See the EU Better Regulation website http://ec.europa.eu/governance/better_regulation/impact_en.htm (accessed 15th June 2012).

the UK, impact assessments are undertaken by regulatory agencies such as the FSA. As was stated by the FSA in relation to the EU better regulation agenda, an impact assessment is designed to help policy makers and legislators make better choices and the assessment is aimed at explaining the problem being addressed and attempting to assess the costs and benefits of the proposed policy as well as that of other policy options.⁹⁵⁹ Regulatory impact assessments should consist of a balanced appraisal of all impacts and wide-ranging consultation with stakeholders as an integral part of the process.⁹⁶⁰ The UK Better Regulation Executive has a guideline for impact assessments,⁹⁶¹ the European Commission has an impact assessment guideline, updated in 2009, and the FSA also works with its own guidelines.⁹⁶² It is important to undertake an impact assessment in accordance with guidelines which are aimed at securing the desired outcome from the exercise. Ultimately, the important issue is to develop a policy intervention which stands the best chance of achieving its purposes, and a regulatory impact assessment is one way of contributing towards this objective.⁹⁶³ In relation to the suggested model, it is the better of other options as discussed earlier.⁹⁶⁴ Nevertheless, it would still be useful to undertake a detailed regulatory impact assessment, taking into consideration all possible impacts, and particularly as a means of determining whether there are aspects of the model which need to be modified in order to conform to peculiar needs and circumstances. For instance, as regards cost issues, the State could undertake to conduct the evaluation exercises if the results of a regulatory impact assessment indicate that it would be the

⁹⁵⁹ See the FSA website <http://www.fsa.gov.uk/about/what/international/regulation> (accessed 15th June 2012).

⁹⁶⁰ See the EU Better Regulation website, (note 958).

⁹⁶¹ See the Impact Assessment Guidance at <http://www.bis.gov.uk/assets/biscore/better-regulation/docs/i/11-1111-impact-assessment-guidance.pdf> (accessed 15th June 2012); see also the toolkit at <http://www.bis.gov.uk/assets/biscore/better-regulation/docs/i/11-1112-impact-assessment-toolkit.pdf> (accessed 15th June 2012).

⁹⁶² See the EC website http://ec.europa.eu/governance/impact/commission_guidelines/commission_guidelines_en.htm (accessed 15th June 2012); see also the 2009 guidelines at http://ec.europa.eu/governance/impact/commission_guidelines/docs/iag_2009_en.pdf (accessed 15th June 2012); see also the FSA guidelines http://www.fsa.gov.uk/pubs/other/mfa_guide.pdf (accessed 15th June 2012). The FSA undertake a Market Failure Analysis (MFA) and a Cost Benefit Analysis (CBA) when proposing a policy initiative.

⁹⁶³ For an analysis of regulatory impact assessments and how they work, see C.A. Dunlop, M. Maggetti, C.M. Radaelli & D. Russel, 'The Many Uses of Regulatory Impact Assessment: A Meta-Analysis of EU and UK Cases' (2012) *Regulation and Governance* (online first publication doi: 10.1111/j.1748-5991.2011.01123.x); see also C.M. Radaelli, 'Regulating Rule-Making via Impact Assessment' (2010) 23(1) *Governance* 89-108.

⁹⁶⁴ See generally the discussions in chapter six.

cheaper option when compared with the cost of engaging private evaluators who might seek to generate the most profit from their endeavours.⁹⁶⁵

7.6 A SKELETAL FRAMEWORK OF THE REGULATION

An outline draft of the suggested model with some of its provisions might be as follows:

CORPORATE GOVERNANCE ACT

An Act to reform corporate governance and make provisions relating to the recruitment of company directors; make recommendations as to the most appropriate personality dimensions for corporate governance; make provisions for the risk management of company directors; and for connected purposes.

BE IT ENACTED as follows:

Chapter 1

Definitional Issues: Companies and Directors

- 1) A company under this Act refers to a public company formed according to the requirements of the Companies Act 2006.
- 2) A company director under this Act refers to a person so called and so appointed in accordance with the provisions of the Companies Act 2006.

⁹⁶⁵ For example, obtaining the NEO PI-R (UK edition) for administering personality evaluation tests would cost £148 for the starter set, £48 for the professional manual, £48 for the guide to interpretation, £44 for reusable item booklets and £62 for the online edition, see <http://www.hogrefe.co.uk/business-psychometrics/personality-and-behaviour-at-work/neo-personality-inventory-revised-uk-edition.html> (accessed 15th June 2012). Training is required for acquiring knowledge on the administration of the tests and these also attract costs starting from £950; see <http://www.neopir.co.uk/> (accessed 15th June 2012); see also http://www.psysoft.com/psysoft_training_open_schedule.html (accessed 15th June 2012). There will also be other costs in relation to the external authority in terms of providing personnel, administration and monitoring functions. The State could undertake to subsidise the operational costs of the external authority in order to reduce the cost of the model to companies, because regulatory cost is a pertinent issue for businesses. See generally the discussions on cost and funding in section 7.1.3 and section 7.2.5.

Chapter 2

Recruitment of Company Directors

- 3) Every public listed company must evaluate the personality of its directors in accordance with the provisions of this Act:
 - a) The evaluation process must be undertaken at the point of recruitment of every director;
 - b) Public listed companies are encouraged to recruit directors who possess the most appropriate personality dimensions for the delivery of effective corporate governance;
 - c) The documents with detailed information regarding personality dimensions and corporate governance are schedules to this Act;
 - d) Companies must engage the services of personality evaluators who meet the requirements of this Act or are accredited by this Act;
 - e) The evaluators must issue a report on the results of the evaluation process.
- 4) Every public listed company must render a report to the approved external authority for the administration of this Act upon the recruitment of a director and the report must include the following information:
 - a) That the evaluation process has been carried out in accordance with the provisions of the Act;
 - b) That the company has taken cognisance of the recommendations as to the most appropriate personality dimensions as stated in the document annexed to this Act;
 - c) That the company has made its selection of directors;
 - d) A document detailing the personality risk dimensions of the directors selected;
 - e) A document signed by the selected directors indicating their acceptance of the evaluation results and its disclosure to the shareholders, external authority and the stock exchange.

Chapter 3

Personality Risk Management of Directors

- 5) Every public listed company that recruits a director who is considered high risk as a result of his/her personality must undertake to place the high risk director/s under a risk management procedure:
 - a) The Act mandates as a minimum the adoption of a standard personality risk management procedure as contained in a Schedule annexed to the Act;
 - b) The company may adopt its own internally developed risk management procedure;
 - c) The company may adopt any other externally developed risk management procedure;
 - d) The risk management procedure adopted must conform to reasonable standards of risk management;
 - e) The high risk directors must consent to the risk management procedure or otherwise lose their positions as directors.

- 6) Every public listed company must render reports to the approved external authority for the administration of this Act, which report must include the following information:
 - a) Whether the company has selected high risk directors;
 - b) That the company has adopted the recommended personality risk management procedure scheduled to this Act; or
 - c) That the company has elected to deploy an internally developed personality risk management procedure, details of which are to be attached to the report; or
 - d) That the company has elected to adopt an externally developed personality risk management procedure, details of which are to be attached to the report, and

- e) That the personality risk management procedure selected conforms to reasonable standards of risk management as recommended in this Act.

Chapter 4

Liability

- 7) a) Every public listed company which contravenes the provisions of this Act is liable of an offence and to a fine of £500,000.
- b) Every director of the company who contributes to the contravention of the provisions of this Act is liable of an offence and upon conviction to a fine of £100,000.

7.7 CONCLUSION

This chapter has discussed approaches to managing personality risks, beginning with a review of existing mechanisms and their limitations, and proceeding to the presentation of arguments and discussions in support of a hybrid regulatory regime for personality risk management. It suggests a regulatory model, and discusses provisions to be incorporated in the model. The chapter also evaluates the model against present corporate governance mechanisms which are aimed at managing behavioural risks, such as the FSA Regime and Companies Act 2006, and highlights the areas in which the model differs. The chapter also situates the model in the present UK corporate governance framework, presenting proposals as to how the provisions of the model could be incorporated into the regime in the event of an entirely new regulatory instrument not being sought. Recommendations are also made as to the most appropriate personality traits for corporate governance, considering discussions in previous chapters. There are also discussions on the import of the disclosure requirements of the model taking account of data protection laws, as well as regulatory impact assessment considerations. The chapter also presents a skeletal draft of the suggested model if a new regulatory instrument is desired. The model is essentially an attempt to identify and manage risks in corporate governance as a means of enhancing effective corporate governance and particularly

to help in the prevention of corporate failures occasioned by personality risks. In the development of suggestions for this regulatory model, particular regard has been had to corporate theories, regulatory theories and principles of effective regulation, cost implications, current trends, current regulatory atmosphere, behavioural issues in examples of corporate failures, and the relationship between personality and behaviour.

CHAPTER EIGHT

CONCLUSION

Morality cannot be legislated, but behaviour can be regulated. Judicial decrees may not change the heart, but they can restrain the heartless.

-Martin Luther King Jr.

8.1 OVERVIEW OF THESIS ARGUMENTS AND ADVANCES

This thesis identifies that behavioural issues can contribute to corporate failures, and seeks to ascertain how and why that is the case, and whether any mechanisms exist to check behavioural issues which impact on the effective delivery of corporate governance. The knowledge that behavioural issues can constitute problems in respect of the delivery of effective corporate governance was obtained from analysing reports issued after investigations into corporate failures. Recent reports such as the Walker Review, the Turner Review and the OECD Reports, as well as reports from previous years such as the HII report all identified behavioural issues as a factor in corporate failures.⁹⁶⁶ The thesis examined these reports in order to ascertain how and why behavioural issues contributed to the corporate failures in question. Also, an examination of investigations into some of the major corporate failures which occurred in the last two decades indicated that company directors behaved in specific ways that were considered inappropriate and which particularly contributed to the corporate failures.⁹⁶⁷ Some of the investigations alluded to the fact that their behaviour was reflective of their personality, as for instance in the Maxwell Group case, the HII case, the WorldCom case and the RBS case in which the CEOs were said to be individuals with domineering personalities. The thesis then seeks to ascertain what constitutes behaviour, and the linkage between personality and behaviour, in order to determine and understand how personality can influence behaviour. Again, it was understood that corporate failures have negative consequences as is evident from the reports and

⁹⁶⁶ See generally the discussions of these reports in chapter four.

⁹⁶⁷ These corporate failures are discussed in chapter four.

investigations illustrating the harm occasioned to individuals and society as a result of the failures.⁹⁶⁸ This means that factors which have the potential to result in corporate failure are risky, because an analysis of risk literature illustrates that risk is the potential for an unwanted negative consequence.⁹⁶⁹ For the reason that behavioural issues can lead to corporate failures, it means that behavioural issues are risk contributors to the corporate governance process. It also means that the elements which constitute behaviour would also be risk elements.⁹⁷⁰ Therefore, risk management in relation to behavioural risks and its constituent elements becomes an important issue, if corporate failures attributable to behavioural issues are to be prevented.

Risk management is a process which is undertaken in corporate governance mainly under the provisions of the Turnbull Guidance, and so an examination of the risk management processes was undertaken in order to ascertain how behavioural risks have been identified and managed in corporate governance.⁹⁷¹ It was found that the Turnbull Guidance provided that internal control was the primary risk management tool in companies.⁹⁷² An examination of internal control provisions as specified in the Turnbull guidance illustrated that behavioural risks were managed from the perspective of instituting structures and processes to safeguard varying situations.⁹⁷³ However, behavioural risks were not identified and managed from the perspective of personality issues and its attendant risks. An analysis of other corporate governance mechanisms such as the UK Corporate Governance Code, Companies Act 2006, and EU Company Law Directives illustrated that there were equally no mechanisms aimed at identifying and managing personality risks.⁹⁷⁴ This situation evidenced a flaw in the system. In any case, it was still important to understand exactly how personality impacted on behaviour in order to make adequate judgements as to how necessary and important it was to pay particular attention to the personality aspect of behavioural risks. Personality is a social and psychological phenomenon and so a journey was undertaken into the foray of psychology. Relevant literature and reports of empirical research were analysed in detail, and it was understood that personality and situations are indeed significant aspects

⁹⁶⁸ The impact and consequences of these corporate failures was discussed in chapter four.

⁹⁶⁹ The meaning and import of risk is discussed in chapter three, section 3.2.

⁹⁷⁰ Ibid.

⁹⁷¹ See the discussions on the Turnbull Guidance in chapter three, section 3.4.

⁹⁷² See The Revised Turnbull Guidance, (note 170) para 19.

⁹⁷³ Ibid.

⁹⁷⁴ See the discussions in chapter three, sections 3.5-3.7; see also chapter seven, section 7.1.1.

of behaviour.⁹⁷⁵ It was also ascertained that personality proved to be more significant in relation to behaviour as it was a concept which determined and influenced responses even in varying situations.⁹⁷⁶ This means that managing behavioural risks without managing personality risks can only prove ineffective. It becomes necessary therefore to develop a personality risk management mechanism in corporate governance if corporate failures are to be prevented. The thesis examines literature on corporate theories, regulatory theories, company boards, corporate failures, risk management etc. and formulates a conceptual framework for personality risk management.⁹⁷⁷ In so doing, there is an examination of possible approaches which can be adopted in regard to managing personality risks. Regulatory options such as adopting an exclusively hard law approach, an entirely soft law approach, or a mixture of both approaches is analysed. Other options such as insurance and certification are also explored. Each approach is discussed with its merits and demerits. Taking account of the negative impact of corporate failures as evident in the examples of failures analysed in chapter four, and considering the duty of the State to intervene in cases of market failure and in the interests of the public, the thesis argues that a regulatory approach is the better option in terms of personality risk management.

The thesis recognises that in order to be effective, regulation must conform to certain principles and those are taken into consideration in the development of the regulatory model proposed.⁹⁷⁸ Considering the vital place of risk identification as understood from an examination of risk management literature,⁹⁷⁹ the thesis argues for mandatory provisions in relation to the identification of personality risks. This is done for two main reasons. Firstly, it is to ensure that the provision is carried out as that is the initial step in any risk management process. Secondly, it is to facilitate the availability of the information regarding the personality of directors to interested parties as that is a piece of information which is essential for the effective functioning of markets as it would enable shareholders to make a more informed judgment as to the level of risk they are willing to undertake in their decision to invest in a company. In recognition of the advantages of soft law provisions particularly in circumstances where one size does not fit all companies, the thesis argues for a situation in which shareholders are still allowed to select their company directors, after they must have

⁹⁷⁵ See the discussions in chapter five.

⁹⁷⁶ Ibid.

⁹⁷⁷ See the literature review in chapter two and the conceptual framework in chapter six.

⁹⁷⁸ See the discussion on regulatory theories and principles in chapter two, section 2.8.

⁹⁷⁹ Risk management is discussed in chapter three, section 3.3.

been provided information regarding the most appropriate personality dimensions for corporate governance. However, in the event that inappropriate directors are selected, the company must then undertake to manage the personality risks accruing from these persons. The model provides suggestions on the provisions to be included in the personality risk management process, but the company is also allowed to develop its own personality risk management process subject to conformity with certain minimum standards.⁹⁸⁰ In consideration of cost issues and the burden of promulgating new legislation, the thesis suggests the inclusion of the provisions of the model in already existing mechanisms, and provides details regarding how this might be achieved in the event that the provisions are sought to be included in the existing UK Corporate Governance Code and Companies Act. However, if a new regulatory instrument is sought, for reasons such as to ensure that all the provisions are in one single regulatory instrument, the thesis also presents a skeletal framework of what the provisions of such an instrument might appear like in order to aid an understanding of the overall import of the model.⁹⁸¹

This thesis has answered its main research proposition which was to ascertain whether behavioural issues are risk contributors to the corporate governance process and whether behavioural risks and personality risks in particular are identified and managed effectively by corporate governance mechanisms. It has done so by examining and analysing corporate failures and psychology literature to determine that personality contributes significantly to behaviour; and analysing existing corporate governance mechanisms and identifying that personality risks are not identified and managed effectively by any mechanism in corporate governance, and so it can be concluded that behavioural risks are not identified and managed effectively either because personality is an essential element of behaviour. In order to ascertain the means of managing personality risks, an analysis of corporate and regulatory theories is undertaken, as well as an examination of risk management theories and current realities as it relates to corporate governance, and a hybrid regulatory model is proposed as an effective approach to personality risk management. The sub-questions stated in the introductory chapter are also answered as follows:

- 1) Corporate failures can be contributed to by the behaviour of company directors as is evident from an analysis of the reports of investigations into these failures and

⁹⁸⁰ Details of the suggested model are discussed in chapter seven.

⁹⁸¹ Ibid.

analysis of the actions undertaken by directors in the examples of corporate failures examined in chapter four.

- 2) The behaviour of company directors can constitute risks to the effective delivery of corporate governance because from the definition and analysis of what risk entails as undertaken in chapter three, corporate failure is a negative outcome, a corrosion of the corporate objective and a peril to society, and so any issue that could potentially result in failure is a risk to the process.
- 3) From an examination of the examples of corporate failures and an analysis of psychology literature, it was found that personality and situations are elements which constitute behaviour and in turn behavioural risks.
- 4) Behavioural risk is not properly identified or addressed in corporate governance mechanisms because personality risk is not properly identified. There is no recognition of personality risk and no provision for its identification. Internal control mechanisms provide for varying situations, but there are no specific provisions targeted at identifying and managing personality risks.
- 5) For the reason that behavioural risk is not properly identified, it cannot and has not been effectively managed. Effectiveness in risk management entails an identification of all the elements that contribute to the risk issue in question as the starting point in the risk management process.
- 6) Personality is a significant aspect of behaviour as is evidenced in psychology literature and the discussions in chapter five.
- 7) Personality is the individual attributes which contribute to behaviour and personality risks are the risks which originate as a result of these attributes, whether appropriate or inappropriate. In relation to corporate governance, the risk of corporate failure is increased in cases where these attributes are inappropriate.
- 8) Personality risk is not effectively managed by corporate governance mechanisms because there is no established process aimed at identifying the risk in the first place. Identifying the risk would mean conducting personality tests using models such as the five-factor model discussed in chapter five, and there is no mechanism in existing corporate governance regimes which clearly mandates those identification processes in relation to company directors of all public listed companies.
- 9) It is important to manage personality risks, because they contribute to behavioural risks, and thereby, reduce the corporate failures which occur as a result of

behavioural issues. These corporate failures have negative effects as discussed in chapter four. Also, the identification of personality risks is essential in order to address the information deficit which is occasioned by shareholders not possessing adequate knowledge regarding the risks which they undertake when investing in a company.

- 10) Personality risks can be managed effectively by developing a process which conforms to the tenets of effective risk management. This would involve identifying the risk and then putting measures in place to manage it by adopting approaches such as avoidance or mitigation. The conceptual framework in chapter six discusses how this can be achieved.
- 11) Different approaches can be adopted to manage personality risks to varying degrees, but each approach has its merits and demerits and these are discussed in chapter six.
- 12) A regulatory framework is a good option because personality risks are significant to the corporate governance process and should be managed with an approach which encompasses adequate provisions that will ensure effectiveness in outcomes. Again, a regulatory framework is justifiable considering that there is a need for the State to intervene for the common good in order to enhance the functioning of markets and help prevent corporate failures. It is also in the interests of the public to have a form of regulatory intervention which would be applicable to all the relevant public listed companies and embody acceptable minimum standards. Chapter seven discusses in detail how such a regulatory framework would work.

Essentially, this thesis has achieved the following advancements, thereby contributing to the literature in a manner that has not been previously achieved:

- 1) Identified and analysed behavioural issues as a factor which contributes to corporate failures.
- 2) Identified and analysed the constituent elements of behavioural issues as it particularly relates to corporate governance.
- 3) Articulated that behavioural issues constitute significant risks to the corporate governance process.

- 4) Argued that the elements which constitute behaviour are distinct and significant risk elements in the corporate governance process.
- 5) Identified that behavioural risks are mostly managed from the perspective of situations as far as internal control measures are concerned.
- 6) Identified that other corporate governance mechanisms do not contain personality risk management processes.
- 7) Analysed psychology literature and identified the linkage between personality and behaviour in relation to corporate governance failures.
- 8) Argued that the conscientious personality and particularly the dutifulness trait is the most appropriate for corporate governance.
- 9) Built on risk management, corporate and regulatory theories in the development of a conceptual framework for personality risk management.
- 10) Argued for a hybrid regulatory model consisting of hard law and soft law provisions in the management of personality risks.
- 11) Presented proposals on the recommended provisions of the hybrid regulatory model.
- 12) Analysed the limitation in other existing mechanisms which seek to manage behavioural and personality risks to varying degrees.

In conclusion, this thesis has adopted ideas on personality which were primarily established in the realm of psychology, and transported those ideas into the realm of corporate governance, as a means of establishing a solution to a problem which has been identified in respect of corporate governance. Using the knowledge that certain personalities are better suited to delivering effective corporate governance, and certain others constitute higher degrees of risk to the governance process, as a tool for managing risks in corporate governance and preventing corporate failures is certainly an essential contribution to the corporate governance literature and would also be valuable in the development of policy aimed at reducing corporate failures.

8.2 LIMITATIONS OF THESIS ARGUMENTS

According to the tenets of the contractual theory, a company comes into being when two or more persons unite for the purposes of engaging in commercial activity.⁹⁸² This means that the company should function under the sphere of private contract law and there is minimal

⁹⁸² See Bottomley, (note 42).

justification for State or public interference by way of regulation.⁹⁸³ Coase and Jensen & Meckling also argue that the company is merely a nexus for contracting relationships, with a view to reducing transactions costs within the market.⁹⁸⁴ In their view, therefore, corporate law exists simply to provide bottom line rules which the entrepreneurs would have had to contract upon separately with their agents. State regulation under the contractual theory should serve simply to enhance the basic functioning of the markets. In this thesis, it has been argued that regulation which aims to ensure that the personality risks associated with company directors are identified and managed is justifiable under the contractual theory because the appropriate behaviour of company directors is essential to the basic functioning of the markets. However, it can also be argued that State interference in that sphere is needless, as entrepreneurs reserve the right to select directors for their companies and should not be subjected to regulation in relation to the personalities of their agents. Under the concession theory, State regulation is acceptable in the interests of the public. But, there are also arguments which suggest that an important element as regards regulation under the concession theory is the consideration of the role of shareholders as owners and preserving their rights.⁹⁸⁵ Consequently, one important question is whether shareholders are able to regulate the operations which the State is seeking to regulate, and if the answer is in the affirmative, then there may be no need for State regulation. So, in the final analysis, the important factor is whether shareholders as entrepreneurs are able to protect their interests as well as those of all other parties which include the public in matters relating to the effective governance of companies.

In relation to the issue of identifying personality dimensions, it has been argued that the presence of specific personality traits implies only a tendency for certain attitudes and actions but does not predict it with absolute certainty.⁹⁸⁶ Also, there are arguments that actual behaviour is dependent on both the personality of an individual and the given situation.⁹⁸⁷ Allport suggests that personality as a whole should be defined as a matter of degree of occurrence of particular traits.⁹⁸⁸ Again, the five-factor model, which is the most widely accepted framework for understanding personality, has been argued as not representing all the possible aspects of personality but rather deals with the important elements of

⁹⁸³ See Sugarman & Rubin, (note 43).

⁹⁸⁴ See Coase, (note 25); see also Jensen & Meckling, (note 29).

⁹⁸⁵ See Dine, (note 57); see also Solomon, (note 57).

⁹⁸⁶ See Hartmann, (note 542) 153.

⁹⁸⁷ See Roberts, (note 555); see also Trevino, (note 134); see also Funder, (note 13).

⁹⁸⁸ See Allport, (note 549).

personality.⁹⁸⁹ There are two methods for identifying personality traits in psychology, the lexical and the non-lexical method, with both methods having certain disadvantages. The lexical method is essentially descriptive and one disadvantage is that language is used as a medium of expression and varies between cultures and countries, and so does not meet strict scientific standards.⁹⁹⁰ A disadvantage of the non-lexical approach is the possibility that some personality traits are redundant.⁹⁹¹ In regard to the NEO PI-R personality test, it has been argued that the results can be affected by reasons such as respondents not being self-aware and careful/careless responses.⁹⁹² Therefore, the identification and description of personality traits may not be absolutely accurate in all cases.

In corporate governance, directors have traditionally been recruited through informal and self-governing methods.⁹⁹³ The nominations committee is simply required to evaluate the skills, knowledge and experience needed by the board and make recommendations regarding the recruitment of directors.⁹⁹⁴ There are no specifications that directors should conform to any specific personality dimensions. Again, in relation to evaluating directors, it has been indicated that directors are generally reluctant to undergo evaluations because the directors feel uncomfortable at the prospect of being assessed and judged.⁹⁹⁵ It has also been argued that evaluation results may also be unreliable as the process may not have been carried out effectively, efficiently and objectively.⁹⁹⁶ Personality assessments would generate results which fall under the purview of personal information, and even though the directors may have consented to the assessments as part of the process of being recruited into company management, they may still have reservations regarding the disclosure of this piece of information to shareholders, fellow board members and regulators. For reasons such as these, directors may not readily accept the idea of personality assessments and subsequent disclosures. This situation might result in some individuals electing not to apply for directorships or to decline such an offer. The pool of directors might in effect be shrunk, and this could influence the availability of individuals to undertake governance roles in companies.

⁹⁸⁹ See Hartmann, (note 542) 168.

⁹⁹⁰ See John et al, (note 595).

⁹⁹¹ See Hartmann, (note 542) 154-155.

⁹⁹² See Hartmann, *ibid*, 159; see also Oh et al, (note 612).

⁹⁹³ See Cadbury, (note 225); see also Dulewicz & Herbert, (note 224).

⁹⁹⁴ See the UK Corporate Governance Code 2010, B.2.1 and B.2.2 provisions.

⁹⁹⁵ See Kazanjian, (note 157).

⁹⁹⁶ *Ibid*.

Despite the above limitations, the thesis provides counter arguments and presents justifications for the approaches adopted. However, it is important to recognise these limitations and take cognisance of the fact that the thesis conclusions which are that personality traits can be identified and therefore the risks associated with them can be managed and that regulatory intervention is necessary and justifiable, could be subject to the effect of these limitations. One vital issue is that policy makers who are usually politicians and likely to engage with the business community in relation to regulatory intervention are bound to evaluate the balance between the arguments which support the thesis conclusions and those which present a concern. It is argued in any case that regulatory intervention in the management of personality risks is essential and justified because the personality company directors influences their behaviour in the governance of companies, and therefore contributes risks which should be identified and managed in order to increase effectiveness in corporate governance and help prevent corporate failures. The personality assessment framework adopted in this thesis are the most widely accepted models and despite their limitations, still remain the most empirically supported structure for identifying and explaining personality issues. In the public interest, it is also argued that it is better to have a smaller pool of directors who are potentially more effective, than a larger pool of potentially ineffective directors who could contribute to corporate failure as a result of their personality. In conclusion, the personality risk assessment model suggested in this thesis is purely a risk management model which takes cognisance of the limitations in regard to personality identification and the impact of personality on behaviour, and so does not suggest that personality should be used as a sole criteria for determining eligibility for directorial roles, but instead suggests a recognition of the inherent risks in relation to personality issues and argues for the identification and management of such risks.

8.3 RECOMMENDATIONS FOR FUTURE RESEARCH AND DEVELOPMENT

Considering the work that has gone into this thesis and the knowledge gained from it, some recommendations for future research are offered. As there is an establishment of the linkage between personality and behaviour, it would be worthwhile to investigate the details of the dynamics between different types of personality traits and corporate governance, in order to have a clear and firm picture of how a combination of traits can contribute to more or less risks in the governance process, particularly as it relates to different roles. It would also be important to investigate how different personality dimensions might fit the governance style in different types of companies, such as manufacturing companies, the service providers and

financial industry entities. Again, this thesis has investigated individual personalities, but it would be vital to ascertain how this individual personality can affect group personality in different situations. Some research has been done on this, with the result that individual personality influences group personality, but it would be necessary to ascertain how it does so in varying situations, particularly from a corporate governance perspective. Ultimately, it would be essential to explore in greater detail the entirety of what personality can contribute to corporate governance as the issue of governance is one which entails the human persons constantly interacting with governance structures in order to produce results, desirable in some cases and undesirable in others.

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